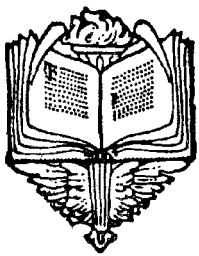
SOME PHASES

OF

FAIR VALUE AND INTERSTATE RATES

BY

JAMES BARCLAY SMITH



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LOUISIANA STATE UNIVERSITY STUDIES

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No. VI. SOME PHASES OF FAIR VALUE AND INTERSTATE RATES

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THIS BOOK IS AFFECTIONATELY DEDICATED

TO

MY FATHER

PREFACE

Jealousy among the several states without common authority was the principal cause of the disintegration of the original confederation. Commercial greed was its basis. The comparative absence of transportation and communication made commercial expansion largely ocean-going. However, there was much bitterness and retaliation employed in limited areas adjoining and adjacent to state lines. The draftsmen of the Constitution were familiar with this condition and with great wisdom created Federal power to control interstate commerce. Modern facilities of communication and transportation have destroyed distance—New York and San Francisco are now closer than were Camden and New York in 1789. Interstate commerce now constitutes the body of internal industrial enterprise. Our economic structure is dependent thereon. The railroads are its arteries and its pulse can be felt through them.

Section 15a of the Interstate Commerce Act, enacted as part of the Transportation Act of 1920, has been vigorously attacked and supported. The problems, difficult enough in themselves, have been unnecessarily confused and complicated. The object of this monograph is to simplify the issues and serve as a basis for departure. Through section 15a Congress comprehensively provided a prophylactic for the disease from which the carriers are now suffering.[1] Unreasonable returns were made available to the needs of the transportation system as a reserve fund in times of business depression. A reserve fund was provided for the use of the earning carrier, to be availed of should its earnings fall short of its needs. The section has never been fully enforced and the funds are not available. Undermaintenance programs and inability to meet fixed charges and pay dividends follow. Normal maintenance programs during temporary periods of depression

[1] "Government ownership would solve the problem * * *." Senate Report No. 304, 66th Congress, 1st Session. Nov. 10, 1919. Senate Reports, Vol. I.

would tend to stabilize industry and employment. The Act contemplates the simplification of the railroad transportation system through consolidation.[2] When this policy is effected the utility of the reserve funds will be enhanced.[3]

Section 15a should be amended and the recapture period fixed at not less than two years. The railroads should be placed on equality with competing systems of interstate transportation.

JAMES BARCLAY SMITH.

December 7, 1931.

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[2] "There is but one other solution. It is consolidation * * *." Ibid.

[3] Cf. Ibid., Part 2.

TABLE OF CONTENTS

PREFACE 9

INTRODUCTION 13

EXCHANGE VALUE 13

REPRODUCTION NEW 16

REPRODUCTION OF THE SERVICE 22

ORIGINAL COST 29

HISTORICAL COST (PRUDENT INVESTMENT) 32

PROBLEMS. BASE AND RATE 35

LEGISLATION 36

SMYTH V. AMES 38

LEGISLATION (CONTINUED) 43

FINAL VALUE 45

PRESENT VALUE 47

RATE-MAKING POLICY. SECTION 15A 49

REASONABLE RETURN. SECTION 15A 53

REASONABLE RETURN 59

VALUE UNDER SECTION 15A 68

SECTION 15A 75

THE VALUATION ACT 85

TABLE OF CASES 93

INDEX 97

INTRODUCTION

If a number of persons are participating in a discussion and each has in mind a different object, or if each has in mind a different characteristic of the same object, no expression is necessarily contradictory of any one expression by a different person. It is only where all have in mind the same characteristic of the same object that it is possible to determine whether the opinions in regard thereto are in accord. Thus it is with the problem of valuation. Value is not a physical characteristic, nor is it a word of definite content. It is as variable as the use to which it is applied and the extent to which it is used on any particular occasion. If the issue involved is condemnation in eminent domain, taxation, special assessment, bankruptcy, fire insurance, the establishment of the upset price in reorganization, foreclosure, security issue, or rate-making, the term value may have a different content in each case. It is the purpose of this paper to study the problem of rate-making in regard to interstate railroads. Hope that something worth-while will be disclosed by unprejudiced examination is stimulated by a deep respect and confidence in the capacity of the Supreme Court of the United States and the fact that Congress made a long and careful study of the purposes involved before enacting the Valuation Act and the Transportation Act. The material is developed at length within the body of the paper rather than in the conventional method in order that this purpose may be accomplished with less confusion.

If it be impossible to discover a common language, it is certainly necessary to translate the several tongues proclaiming their particular theory in order to observe wherein they differ. Little originality is claimed in the philology which follows in epitome.

Exchange Value

The capitalization of anticipated net earnings under a specified rate is the primary test of "market" or "exchange

value." It is the price the properties would command as between a willing buyer and a willing seller. It is sometimes stated as the price for which the property would sell under ordinary conditions otherwise than at a forced sale.[1] The basis of this estimate, and it is an estimate,[2] is the earning power of the business as a going concern. But earning power depends upon rates and where the rate is the issue to use exchange value as the rate base is to establish rates by the rates themselves. Therefore, since market value is primarily a capitalization of earning power and earning power depends upon rates, we can not find rate-making "value" by exchange standards. If exchange value were the base in rate-making, no rate could be reduced without a destruction of property because ordinarily property would be destroyed to the extent that capitalization of rates under reduced rates is less than under existing rates.

Although the Supreme Court has definitely, continuously and repeatedly rejected exchange value as the rate base for more than a quarter of a century,[3] we still find able counsel dramatically asserting its relevancy (sincerely, of course).[4]

Prior to 1898 the Supreme Court treated the question of value in regard to taxation and condemnation. In each the purpose is to leave the individual in as good a position comparatively as if he had not been visited by the state—in condemnation to leave him with what he could have sold for at the time; in taxation in a position in comparison with other taxpayers so that their relative position is maintained. The

[1] Louisiana General Tax Law, Act No. 170 of 1898.

[2] Cf. New York Central Acquisition of Ulster & Delaware, 1931, 175 I. C. C. 65.

[3] San Diego Land and Town Company v. National City, 1899, 174 U. S. 739; San Diego Land and Town Company v. Jasper, 1903, 189 U. S. 439; Stanislaus County v. San Joaquin, etc., 1904, 192 U. S. 201; Knoxville v. Knoxville Water Company, 1909, 212 U. S. 1; Wilcox v. Consolidated Gas Company, 1909, 212 U. S. 19; Cedar Rapids Gas Company v. Cedar Rapids, 1912, 223 U. S. 655; Simpson v. Shephard, 1913, 230 U. S. 352; Des Moines Gas Company v. Des Moines, 1915, 238 U. S. 153; Galveston Electric Company v. Galveston, 1922, 258 U. S. 388.

[4] Excess Income of Illinois Terminal Company, F. D. No. 3765, I. C. C., June 30, 1931.

court was neither ignorant nor careless in excluding this test of value from the rate base in *Smyth* v. *Ames*. The legislature enacting the Valuation Act definitely recognized that exchange value, or a value determined by earnings, could not be considered where the issue is the reasonableness of such earnings. "Therefore * * * the income actually in enjoyment cannot be a factor in determining the value of the property at all, because that is the very unknown quantity we are endeavoring to make specific."[5] "The very purpose * * * of this bill and the valuation that is proposed is to enable us to ascertain in a proper way whether a given income enjoyed by a particular common carrier is too large or too small."[6] "The probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses," is often quoted from *Smyth* v. *Ames* as requiring a capitalization of earnings in fixing the rate base and so a part of the law of the land under Federal statutes. But as the Court was familiar with the measure of value in condemnation and taxation cases and within a year after *Smyth* v. *Ames* sanctioned a reduction of rates at the same time that it affirmed the facts evidentiary of value as there declared for rate-making, it must not have intended exchange value as a measure of the rate base. The above quotation was not used in that case to establish capitalization of earnings as a test of value but was used in connection with rate-making policy (as will subsequently be shown) to test a rate which, operating in the future, will provide a reasonable return without the need of immediate revision to avoid confiscation.[7]

The rejection of exchange value by both the Court and the Congress as the measure of value for rate-making purposes is clear.

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[5] Senate Report 1290, 62nd Congress, 3rd Session.

[6] Ibid.

[7] Cf. Newton v. Consolidated Gas Co. of N. Y., 1922, 258 U. S. 165—"When it became clear that the prescribed rate had yielded no fair return for more than a year, and that this condition would almost certainly continue for many months, the company was clearly entitled to relief."

Reproduction New

In 1898 the lines of the Union Pacific could, under the conditions then existing, have been built across the State of Nebraska for about $20,000 a mile. Because of "injudicious contracts, poor engineering, unusually high cost of material, rascality on the part of those engaged in the construction and management of the property,"[8] under the conditions existing at the time of construction, the lines of the carrier cost more than five times this much to security holders. The tendency during the first decade of the twentieth century of these costs was to equality. Since that time the cost of reproducing carrier property at any given time has exceeded, in most cases at least, the expenditure for their construction. In *Smyth* v. *Ames* the carrier contended for a valuation measured by the securities issued and bitterly opposed the argument of the state for the then cost of reproducing the properties. As the two approached each other the importance of either position decreased, as results were similar. As the cost at any given time of building similar property became the greater, and as the trend remained rather constantly upward, while the value once claimed remained constant, reproduction new became the lodestone of the carriers in all valuation for rate-making. Finding no embarrassment in changing their position, they naturally sought to fortify their new entrenchment. They argued first that the word "present," adjective of "value," called for a complete review and revaluation in reaching a "reasonable judgment" figure on all evidentiary facts thereof for and during each rate period. As the trend was upward, this was consistently self-serving. Second, that the present cost of reproducing the existing property is the exclusive measure (plus, of course, going value, etc.) of value for rate-making. "This insistence upon cost of reproduction new at current prices to the exclusion of everything else, or at least everything that might tend to lower value, calls for the closest scrutiny."[9]

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[8] Ames v. Union Pacific Railway Company, 64 Fed. 165, 177.

[9] Excess Income of the Manufacturers Railway Company, 1927, 124 I. C. C. 3.

The cost of reproduction is asserted by its proponents as the true basis of what the present physical plant is "worth." The difficulty here is that, if we inquire of present worth of the existing plant, we must look at it either as a living concern, or at it dismembered, or assembled but devitalized. The first calls for a capitalization of earnings, which valuation is irrelevant as evidentiary of value for rate-making. The second commands only scrap value and the third is beyond the realm of facts. Why speculate what an imaginary new company would pay for the plant without a franchise in preference to building an imaginary new plant? Neither such new company nor such purchase is possible under the facts. The plant is part of a going business. This test would call for cost of reproducing the service and not measure physical value of the existing plant. Assuming our imaginary buyer would look only at the plant without the business, it is obvious that in contemplating the construction of a new plant he would be concerned only with the duplicating of the service, or the production, not of an identical plant, but of a plant of equal capacity. New invention (obsolescence) may make this possible at a fraction of the cost of building an identical plant.

The reproductionists claim allowance for unearned increment because, it is said, there is no reason for allowing it in competing businesses and denying this stimulus to investment in utilities. It is further said to be a social loss to permit a return on property for the use of which consumers would pay more for some other property.

First, last, and always, public utilities are not unregulated, freely competing enterprises. There is no certainty that buyers would exist for the imaginary other purpose. The argument involves the use of an element sought to be found as a means of finding it. If the community is willing to pay for the utility service at a reasonable rate, it is as socially desirable in this sense as any other service. Neither does the theory solve the question of economic waste in a monopolistic road serving traffic which would not move under

a rate high enough to yield a normal return on present construction costs, because the present construction cost to measure economic justification would be the cost of reproducing the service through the most efficient hypothetical new plant imaginable and not the present, partially obsolete, plant.

Without emphasizing forces of competition in unregulated fields, the argument is frequently made in favor of reproduction new as the only means of securing new construction. If new lines are to be built, the cost is measured by prices at the time of construction and return must be allowed on these prices. But as the new line would compete with existing lines and if their rates were limited to prudent investment their rates would be lower than the new carrier could meet without sacrifice of investment and, therefore, new construction will be discouraged unless reproduction new is adopted as the rate base. In parallel it is argued that reproduction new will encourage just enough construction to handle economically justified traffic demand. The fallacy of these arguments is indicated above. It should be noted also that it is a fallacy to segregate additional earnings and new capital required for extensions from earnings and cost of the entire plant. History has shown the utter futility of attempting to enforce such a theory.

The cost of reproduction seems to fluctuate more widely than any other suggested rate base. This is so because it is totally an estimate making possible extravagant assertions as well as wide differences of opinions expressed in good faith. In *United Fuel Gas Company* v. *The Railway Commission*,[10] upon the same subject matter, two experts for the same party differed more than $6,000,000, more than 20 per cent from each other, and their average differed from the expert's opinion on the other side more than $20,000,000, or more than 200 per cent.[11] This difficulty is enhanced by the fact that

[10] United Fuel Gas Company v. The Railway Commission, 1929, 278 U. S. 300.

[11] Cf. Ottinger v. Consolidated Gas Company, 1926, 272 U. S. 576; McCardle v. Indianapolis Water Company, 1926, 271 U. S. 23.

there is no check or balance fixed to weigh against the conclusion reached. Aside from the individual differences vertical fluctuations have been violent. Its utter instability as a rate base is shown by the annual fluctuations. The round number carrier valuation under cost of reproduction new was eighteen billions in 1919, forty-one billions in 1920, thirty-five billions in 1921, twenty-two billions in 1922, and thirty-one billions in 1923.

During this period the net additions and betterments were around four billions. It would obviously have been much cheaper for the country to have *given* the carrier these additions than to gratify the reproductionists' theory of attracting new capital and so to have permitted the increase of the public debt some twenty billions. The opposite consequence attaches to the *expenditures* actually made during high prices—*nearly fifty per cent would have been wiped out within a year.* This instability is enhanced by the uncertainty of the time when revaluation may be made. Theoretically it should be made with each material shift, but this would mean the breakdown of all regulation.

Undaunted, nevertheless, Samson still sends forth his firebrands, alleging that the brightness thereof will attract the capital moth through unearned increment. But at least two thirds of the outstanding securities are fixed income and so unaffected while the balance in common shares becomes a wallow.

The companion argument is that reproduction new by following prices stabilizes income and stimulates construction during low cost periods in order to gain advantage of future rises. If the secrets of the future were available to many, or to any, there would be no secrets. Secondly, the utility cost cycle does not correspond to other cost cycles. From 1913 to 1925 there was an increase in all-commodity prices of fifty-nine per cent while during the same period utility construction increased as follows:

Electric railways	102 per cent
Telephones	67 per cent

Electric power	78 per cent
Gas	130 per cent
Water	133 per cent

The following tables show in some detail the fallacy of this argument:

Railroad construction	*Year*	*All-commodity wholesale prices*	
100	1910-1914	100	
101	1915	100.8	
118	1916	126.8	
147	1917	177.2	
177	1918	194.3	
196	1919	206.4	
220	1920	226.2	(peak May, 1920, 246.7—Dec. 1920, 179.2)
175	1921	146.9	
160	1922	148.8	
180	1923	153.7	
179	1924	149.7	
171	1925	158.7	
172	1926	151.0	
171	1927	146.8	
171	1928	142.7	

This comparison for rate-making purposes is complicated by the fact that railroad construction cost is in turn affected by changes in the general rate structure which substantially affects all commodities used in the construction and operation of railroads. The table does show that the recession in the cost of railway construction has been less than in the broader field of general commodities.

The reproductionists answer the allegation that reproduction new as a base is expensive, uncertain and highly litigious by the assertion that it is simple and stimulative of efficiency. Administratively simple because it can be brought to date by index multipliers. The practical difficulty with the multiplier argument is that there may be no facts upon which reliable multipliers may be computed. For example, during the years 1920-1923 there was little or no railroad construction. The

multipliers during such periods must be compiled largely from manufacturers' records and price statistics, but these, as we have seen, do not allow for improved methods of assembly and construction. An increase in the former might be balanced by decreases in the latter. From the date of *Ames* v. *The Union Pacific Railway* to 1914, because of economies, railroad construction did not vary greatly although wide differences occurred in the prices of labor and materials. Taking the wages, etc., index with 1919 as 100, 1920—230, 1921—195, 1922—157, and 1923—194, the change in rates would be: 1920—increase of 114 per cent, 1921—decrease of 14 per cent, 1922—decrease of 18 per cent, and 1923—increase of 10 per cent. This would hardly have been attractive to capital.

Disregarding the differences indicated by the above tables multipliers are not applicable to the intangibles claimed, and are not even applicable to the physical property if the reproduction new base is measured by the cost of duplicating the service rather than duplicating an obsolete equipment. The efficiency argument has been made only during the periods when the cost of reproduction new has been so great that regardless of efficiency a reasonable return thereon could not be exceeded.

The rate changes made during this general period were: 1917—fifteen per cent increase; 1918—twenty-five per cent increase; and in 1920—forty per cent increase in the Eastern territory, thirty-five per cent in the Western territory, and twenty-five per cent in the Northern and Mountain territory.[12] In July, 1922, the Eastern forty per cent increase was reduced to twenty-six per cent, with other reductions in other territories.[13]

The rate assured the carrier during the period of Federal control was based on average net railway operating income for the three years June 30, 1914-1917, inclusive. This was

[12] Increased Rates, 1920, 58 I. C. C. 220.

[13] Reduced Rates, 1922, 68 I. C. C. 671. Cf. Ex Parte, 103. July, 1931, Application for fifteen per cent Increase.

determined without regard to prices. Business judgment precluded a demand for a return which would produce a reasonable return upon the cost of duplication. Public indignation would not have tolerated such exorbitant charges where no expenditure had been made in the nature of loans advanced. Like the fox who measured his fatness against the size of the avenue of escape, the carriers acquiesced in the base used in the 1920 increase. In their application in 1926 a similar complacence is exhibited. At no time during the period of 1920-1926 did the carriers as a whole receive as much as 6 per cent on reproduction new cost but during this period the market for their securities improved and the trend of interest was downward.

If reproduction new had been the base, the rate increase in 1920 rates would have been increased from about seventy-five to ninety per cent instead of from about twenty-five to forty per cent. Always assuming the long-suffering consumer would acquiesce, the profits would have flowed to the common shareholder. The converse of this in duplication is what makes the base attractive to the market manipulator.[14] For example, the 1920 prices as compared to the 1914 prices would have justified doubling the security issue while at present nearly half of these would be clear water. These wide fluctuations make the fixing of rates for any period of reasonable duration impossible with the result that adjustment must have been made very frequently if the cost reproduction new were the exclusive measure of the rate base.[15] Nothing is more disrupting to industry than abrupt shifts in general rate levels.

Reproduction of the Service

If we were confronted with the task of building a new plant, we must duplicate the existing plant or build one that

[14] Cf. Re City of Grand Rapids, P. U. R. 1923C, 494-495.

[15] Cf. Bay State Rate Case, Mass. P. U. R. 1916F, 221 233; Westchester Street Ry. Case, 1912, 3 P. Ser. Comm. Rep. (2nd Dist. N. Y.) 286, where Commissioner Stevens said, "If it (the Commission) takes reproductive cost only to be that value, it goes contrary to all experience and all sound canons of judgment"; Douglas Co. Light and Water Company Case, (Oregon) P. U. R. 1920E, 666, 674; Hill v. Antigo Water Company, 1909, 3 Wis. R. C. R. 623.

is different. Competition operates in marketing commodities and obviously in industries controlled (if unrigged) by competitive forces only, the entrepreneur is concerned only with what it will cost him to place the commodity on the market. He is not interested in duplication of obsolete machinery but with the cheapest and most efficient modern devices. The test of rates under such conditions is supposed to be just about the point where a competitor can afford, or can not afford, to enter the field. If a gay young dolphin will offer speedy open-air passage, why travel steerage with a slow-going whale? Therefore, the value of the new business or plant is about the cost of duplicating the service rendered. Thereby it is said efficiency will be spurred to the maximum and economic waste will be prevented because just the proper amount of capital and no more will be devoted to any particular industry. Monopoly prices will be impossible. We must imagine a new plant, and imagine new operating expenses, and imagine what sacrifice must be endured to bring this imaginary plant to assumed normal production.

If exchange value, value in condemnation, or what a willing buyer will pay, were the issue, duplication of the service must be considered because our buyer will not pay more for an existing plant than he thinks he could build just as good a plant for. To the extent that the service may be duplicated by more efficient modern machinery, obsolescence, or functional depreciation, has accrued in the existing plant. This may go so far that the old plant is of little or no value for sale. It might occur in the briefest period of time through new invention and although there has been no physical depreciation. So far as the cost of reproduction is advanced as the exclusive test of value for rate-making, the force of this attack is overwhelming. Proof of value by evidence of reproduction cost presupposes that a plant like that being valued would then be reconstructed, but this would not be true if its parts were obsolete. In valuation for rate-making, contrary to the reproductionist, reproduction new is not the sole base, but the cost at the time of valuation of duplicating the phys-

ical plant used and useful to the public service is taken as evidence or a guide in reaching a reasonable judgment of the amount reasonably necessary and actually expended in its production. Need we repeat that utilities are not freely competitive and that exchange value is irrelevant?

Functional depreciation which has nothing to do, through the mere fact of its accrual, with the fair value of the plant is a matter that should be considered in every intelligent accounting system. Because of the fact that sooner or later the present equipment must be replaced, depreciation charges should be set up against railway operating income. The purpose here is to spread the loss to the lender over a long period. But as the function of value and rate-making is to protect the fair investment,[16] functional depreciation not so provided for can not be deducted.

The "honest, efficient and economical management" of the Transportation Act has reference to facts (as is shown elsewhere in this paper) and has nothing to do with the realms of metaphysics. Since sale, new competitors, etc., are irrelevant, the capital attraction and protection aspects are relegated to the capital costs in fact of the thing we see, feel, deal with, and depend upon.

Functional depreciation may accrue through competing enterprises although the special field is closed—busses may cut patronage. In this way functional depreciation may become important in rate-making policy. A lowering, or other rate adjustment, may multiply traffic so as to produce a reasonable return. It may be that no adjustment of rates would produce a reasonable return. The fact that no interest is paid does not disprove the loan. Furthermore, there is no constitutional guarantee to the lender of a fair return. His right is limited to a freedom from interference with returns less than a fair return.

While it is true that the difference between scrap value of existing property and the cost of building a modern, efficient,

[16] Pac. Gas & Elec. Co. v. San Francisco, 1924, 265 U. S. 403—"Our concern is with confiscation. Rate making is no function of the courts."

new plant is the same to whatever be due the failure to make the replacement, and the Court says in *Public Utilities Commissioners* v. *New York Telephone Company*,[17] "consumers pay for service, not for the property used to render it," the cost of reproducing the service is not the rate base, nor even a fact evidentiary of such value. The consumers pay for the service but they pay for the reasonable cost of service received under efficient operation of the existing plant, and the cost of the service above quoted means what reasonable outlay was necessary to render service received. This is shown by the facts in that case, and other statements by the Court. There was no issue of reproducing the service, but merely if future deficient earnings could be made up from past excesses. These excesses had been plowed into the plant, and of them the Court says, "the just compensation safeguarded to the utility by the 14th Amendment is a reasonable return on the value of the property used at the time it is being used for public service," and "constitutional protection against confiscation does not depend on the source of the money used to purchase the property. It is enough that it was used to render the service." Obviously reproduction of the service may be a belaying-pin to the reproduction new proponents, but careless use of language in one instance can not be made to spell reproduction of the service as the rate base out of the *New York Telephone Case*. Of course the public pays for service. I should not pay subsidy to the Edison Company merely because it owned a plant if no electricity is furnished. But again we live in this mundane world and not in some imaginary other place, and it is "compensation for the service given to the public,"[18] a vulgar fact, with which we are concerned.

If we must torture ourselves into such a frenzy that we can disbelieve the existence before our eyes of a four hundred ton engine pulling a train of more than a mile in length at

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[17] Public Utilities Commissioners v. New York Telephone Company, 1926, 271 U. S. 23, 32.

[18] Simpson v. Shepard, 1913, 230 U. S. 352.

forty or fifty miles per hour, and of the track on which it runs, then we must scout about to find where our new pet is to be built and so reconnaissance ought to be allowed. Also in our flights of speculation we should consider the business—compelling position of the existing carrier—if we are seeking a sale price, because if a road in any other place would be less advantageously located the existing business approaches monopoly power. Such purely speculative theory is immaterial[19] and irrelevant, as are exchange values and sales prices. In the *Consolidated and Des Moines Gas Cases* value not represented by legitimate expenditure was excluded.[20]

There is no case in the history of the Supreme Court from 1789 to 1931 wherein the Court does not refer to the "cost" of property in connection with fair value for rate-making. To ascertain this cost all relevant facts must be weighed and a reasonable judgment reached without the aid of formulae. It is in this that the cost of reproducing the present physical plant is a relevant evidentiary fact. The plant presently used at the time of determination of such ultimate fact is taken because that represents tangibly a major portion of the cost to the lender to produce the service rendered. "Present" plant eliminates from consideration an imaginary plant and obviously physical depreciation must be subtracted or we would not be dealing with facts but with some different hypothetical plant. This is the element called for in *Smyth* v. *Ames* and all cases since that date. At the time that case arose there was no reliable evidence of single source of that reasonable expenditure necessary to produce the plant existing at the time of valuation. The issue was purely judicial—the ascertainment of that fact. As in tort or crime or any other type of issue, the Supreme Court indicated evidentiary facts which must be considered in a judgment of ultimate fact. Is there any formula or rule of thumb for judicial determination of fact in such cases? What it would now

[19] Ibid.

[20] Wilcox v. Consolidated Gas Company, 1909, 212 U. S. 19—franchises; Des Moines Gas Company v. Des Moines, 1915, 238 U. S. 153—as to paving.

cost to build that plant was judicially noticed in *Smyth* v. *Ames* as not the fact sought but was required by the Court as a check, measure, or evidentiary fact. In the *Southwestern Bell Case,*[21a] where no issue of plant efficiency was involved, the State Commission had not followed *Smyth* v. *Ames* in that it did not consider the cost of reproducing the plant in use at the time of valuation, but in lieu of that cost used an amount more than twenty-five per cent less. Adherence to *Symth* v. *Ames* required a rejection of the State Commission's determination.

The language of Mr. Justice Butler "it is clear that a level of prices higher than the average prevailing in the ten years ending with 1923 should be taken as the measure of value of the structural elements on and following the effective date of the rate order complained of" in the *McCardle Case,*[21] has been mistaken as a benediction by the reproductionists. We search in vain for any expressed intention on the part of the Court to overrule *Smyth* v. *Ames.* The discussions by the Court arise from the statement by the State Commission whose determination was in issue. They say:

"Considering all the facts, including all the appraisals and other evidence concerning the trend of prices, the Commission is of the opinion that in this case the average prices for the ten-year period ending with 1921, the last ten years available, most nearly represent the fair value of the petitioner's physical property."

The end of this average period was more than two years before the rate order became effective. While the average price so determined was higher than the original cost, it was lower than the cost of reproducing the plant at the time of ascertaining the legitimate expenditure to produce it. An arbitrary figure was taken, a formula, in effect, which was not even one of the evidentiary facts required by *Smyth* v. *Ames* to be considered. The peculiar localization of this service strongly demanded the consideration of the evidentiary fact of value, namely, the cost of duplicating the physical

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[21] McCardle Case, 1926, 272 U. S. 400.

[21a] Missouri ex rel. Southwestern Bell Tel. Co. v. Public Service Commission, 1923, 262 U. S. 276.

plant at the time its value for rate-making was being determined, but the *McCardle Case* is not a holding that the cost of duplication of either the plant or the service is the exclusive measure of value for rate-maknig.

If a study of the case itself leaves this conclusion in doubt, we may look to the subsequent explanation of the Court itself to glean its intention in the *McCardle case.* In the *O'Fallon Case,*[21b] citing decisions from *Smyth* v. *Ames* to the *McCardle* Case, inclusive, the Court says:

"The elements of value recognized by the law of the land for rate-making purposes have been pointed out many times by this court. *Among them* is the present cost of construction or reproduction." (*Italics supplied.*)

Further, and consistently adhering to its long-declared policy that this expenditure be determined in reasonable judgment weighing all relevant facts, the Court refrains from stating a formula, saying, "the weight to be accorded thereto is not the matter before us. No doubt there are some, perhaps many, railroads the ultimate value of which should be placed far below the sum necessary for reproduction." (Is there a formula in tort, crime, or contract that fits all cases?)

The function of the cost of reproduction in the Valuation Act and Transportation Act must be considered. We have seen that the cost of duplication is purely speculative, prohibitive in expense to apply, and so fraught with possibility of fluctuations as to be most unwholesome if applicable. No body has been better informed of these defects than the Interstate Commerce Commission. In its council to Congress we find repeated expression by its members, individually and collectively, that the cost of duplicating the plant should not be the exclusive evidence of final value. As an aid in determining legislative intent these expressions indicate that final value once determined may be brought down to date, as actually required in section 19a, by accurate accounting of net additions, etc. This would eliminate a reconsideration of the evidentiary facts considered (or revaluation) in reaching a

[21b] St. Louis & O'Fallon Ry. Co. *v.* United States, 1929, 279 U. S. 461.

reasonable judgment of final value. *Revaluation* is not bringing the final value down to date through additions, etc. Not only do the annual reports of the Commission show, in so far as they indicate legislative intent, that final value is not the cost of duplication, but that the object sought through legislation was the "fundamental proposition that the actual investment in an enterprise needed for giving the public adequate transportation facilities is entitled to and should have a reasonable return, and no more than a reasonable return, in the form of constant profit, and a reasonable schedule of rates is one that will produce such a result." [22] It has already been shown that either theory of reproduction new would preclude the return of constant profit. In no place is there the slightest suggestion of approval of the cost of reproduction of the service. The fundamental proposition is ascertainment of investment. If doubt remained as to legislative intent, it was settled in the *O'Fallon Case,* where the Court tells us "Congress has directed that values shall be fixed upon a consideration of present costs *along with* all other pertinent facts." (*Italics supplied.*) These are the relevant facts evidentiary of prudent investment required for consideration by the opinions of the Court and the requirements of Congress in section 19a.

Original Cost

One of the oldest of the various so-called rate bases is "original cost". It is the total financial sacrifice incurred by the security holders. It is immaterial to this base whether the expenditures in setting up the properties were frugal or prodigal. It does not deal with present properties. The base is permanent in quantity and is brought to date merely by adding net expenditures. It is permanent or fixed in the sense that we refer to a fact, how many dollars have been contributed to the enterprise. This was the base contended for by the carrier in *Smyth* v. *Ames* but it was not accepted there and has subsequently been rejected by the court as the

[22] Annual Report, 1908, page 84.

exclusive base.[23] While the court has definitely rejected this base as it has the cost of duplicating the physical plant or reproduction new, both of which were claimed by the respective parties in *Smyth* v. *Ames* as the exclusive measure of value for rate-making purposes, it has recognized each as one of the relevant facts to be considered in reaching a reasonable judgment of the cost of the plant.

As the original cost theory deals only with the sum contributed, obviously the elements of depreciation, appreciation,[24] and unearned increment are wholly irrelevant.[25] Going value is relevant as the failure to obtain a return on the investment until the business norm is reached is a loss or part of the contribution or financial sacrifice of the investor. The chameleonic use of the word "depreciation" has led to much confusion. *Smyth* v. *Ames* requires by its one statement the subtraction of physical depreciation of the structural properties valued in order to establish what the structural properties are. Consequently, a consideration of physical depreciation is proper in all rate values. But the deduction of physical depreciation from one of the evidentiary facts does not mean that it is to be deducted from each, or any other, or the judgment estimate. This confusion has led some to feel that the action by the Supreme Court in the *Bluefield Water*,* *Southwestern Bell* and *Galveston Electric cases* is approval for depreciating original cost. Nothing is further from the fact. Equally obviously, it would be appropriate, using depreciation as equivalent to amortization, to set up monthly or annual depreciation or amortization charges and when so set up should be deducted from the base, original cost.[26] This

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[23] San Diego Land, etc. v. National City, 1899, 174 U. S. 739; San Diego Land, etc. v. Jasper, 1903, 189 U. S. 439; Stanislaus County v. San Joaquin, etc., 1904, 192 U. S. 201.

[24] Wilcox v. Consolidated Gas Co., note 20.

[25] Cf. Cedar Rapids Gas Light Co. v. Cedar Rapids, 1912, 232 U. S. 655; Des Moines Gas Co. v. Des Moines, 1915, 238 U. S. 153; Galveston Electric Co. v. Galveston, 1922, 258 U. S. 388; Georgia Power Company v. The Railroad Commission, 1923, 262 U. S. 625.

[26] Cf. Pac. Gas, etc. v. San Francisco, 1924, 265 U. S. 403.

*Bluefield Water & Improvement Co. v. Public Service Commission, 1928, 262 U. S. 679.

is so because these are in effect a repayment of the loan, and to the extent repaid is no longer owed. This confusion has led to citation of such cases as the *United States* v. *Ludey*,[27] as authority for depreciating original cost. But this case is neither an aid to the reproductionists nor authority for depreciating original cost in rate valuation. It may be used in analogy as authority for subtracting from value under *Smyth* v. *Ames* a sum set aside as depreciation reserve in amortization, but it has no bearing on the function of physical depreciation either under the original cost theory or in reproduction new. The *Ludey case* arose under the Federal Income Acts. "Gain" thereunder is the selling price minus cost. Cost must be diminished by depreciation and depletion allowable as deductions. Before gain can be determined, these computations must be made. Since their use was to ascertain whether or not the cost had been exceeded by the return, it was necessary to allow the amount of depreciation, which had been allowable as a deduction from gross income, as a deduction from cost. The function of the allowance was to equate selling price and cost. The depreciation allowable as the deduction in gross income was analogous to a sale to that extent. Under the statute these proceeds could not be touched until they exceeded cost. The purpose of the state to this extent was not to interfere with the money of the taxpayer until his financial outlay had been inlayed. Thereafter he could have all he could make over a certain percentage. In rate-making a somewhat similar base might be subject to amortization and over the amortization charges the utility might have all it could make up to a certain percentage but no more. Certainly, the *Ludey Case* is not authority for subtracting physical depreciation from original cost in valuation for rate-making.

The outstanding virtue of the original cost as an exclusive base is the simplicity of administration and the alleged stability of return. It is very interesting to note the shift of the carrier from the position in *Smyth* v. *Ames* to the ex-

[27] United States v. Ludey, 274 U. S. 295.

tremely complicated reproduction new. If the trend of prices continues indefinitely downward, it may be that "the turning away from the simple shall slay them and the prosperity of fools shall destroy them." With much justification the original cost base is attacked on the ground that its outstanding supposed virtue of stability is mythical as it links return to the dollar and due to inflation no real stability results; and because expenses are at current costs while the return is on expenditure only. These claims are identical and well founded. They apply with equal force to any theory which multiplies together two fixed elements for rate-making purposes.

While original cost has never been recognized as the exclusive base for the reasons pointed out in *Ames* v. *The Union Pacific,* but since the Court is always looking for the amount that was reasonably necessary to produce the properties at the time of their construction, it naturally called in *Smyth* v. *Ames* for a consideration of what was actually spent, and then proceeded to enumerate other evidentiary facts to be weighed against original cost to ascertain how much it should be reduced. As stated by the Court in *Regan* v. *Farmers Loan & Trust Company,*[28] "justice demands that every one should receive some compensation for the use of his money or property if it is possible without prejudice to the rights of others". Therefore, original cost is primarily emphasized in *Smyth* v. *Ames* and always since approved, subject to the ascertainment of the extent to which it was, or is, unfairly prejudicial to the rights of others.

Historical Cost (Prudent Investment)

The original cost described as total pecuniary sacrifice to the investor is distinguished from "historical cost". The latter refers to the actual cost of the present property.* While this base deals with present property, it is measured by the actual cost as a matter of history as distinguished from the present cost of duplication. The historical cost base is fre-

[28] Regan v. Farmers Loan & Trust Company, 1894, 154 U. S. 362.

* Cf. "Original cost" under Valuation Act, infra page 43.

quently confused with the "prudent investment" base. Each deals with the present property and with its cost, but prudent investment delimits the cost of the present property to a reasonable expenditure—the amount which under honest and efficient management would have been adequate to produce the property at the time of its construction. The less imprudent and dishonest the construction expenditure, the nearer original cost approaches historical cost, and the latter, in turn, the prudent investment. Historical cost is sometimes used as nearly synonymous with prudent investment. In this sense it does not mean the historical narrative or enumeration of expenditures, but the history of prices contemporaneous with the construction of units used in the plant as a measure of prudent expenditure.

The historical cost is subject to the same lack of reliability as original cost with few of its merits as a measure of legitimate loan. Historical cost, prudent investment, and original cost offer simplicity of administration and alleged stability of return. None are subject to charges for physical depreciation and to all should be added going value. Stability of income and credit under each is said to be fictitious as an attempt to produce stability of real income by tying it to the dollar. It is said to discourage initiative in promotion and management as no inducement exists to improve service beyond the point of maximum return. This latter argument was developed by the reproductionists during inflation of costs when the current costs of duplication would be much greater. As the carrier would be entitled to a return on current costs, he would be stimulated to improve the service. It is also said that with competing roads of greatly different construction cost the road of the highest cost would be strangled because its competitors could charge less and still make a reasonable return, etc. To this is answered that intelligent regulation under uniform rates should reinvest proceeds so as to reduce public charges and indebtedness. The Transportation Act deals specifically with the situation. Through combination, competition is to be reduced. The recapture of

excess earnings of the low-cost carrier constitutes a rate adjustment and eliminates unreasonable rates. It is also said that on a long continued downward cost trend that a point would soon be reached at which public resentment to a return on an amount so greatly excessive of current reproduction costs, that cost bases, however determined, must be abandoned.

It is postulated in this paper that original cost, historical cost, security issue and reproduction new are definitely and clearly not exclusive measures of the rate base. Historical cost has not been treated specifically by either the Court or Congress as it is included in original cost as used by them. These so-called rate bases have all been required by the Court as aids to finding the prudent investment and this wise counsel has been incorporated into statute. The legitimate assault by the reproductionists upon the prudent investment, namely, that it fails to produce stability because it links return to the dollar, is dealt with elsewhere herein.

Other things being equal, return is the rate times the base. Discussions of the various rate bases generally treat without explanation of the problem as if the multiplier (with the possible exception of the cost of reproduction of the service) was for some unexplained reason immutably fixed and, therefore, if reasonableness is the complexion of the product, necessarily the multiplicand must be hitched to business, construction, and commodity cycles, to keep the product from blushing. In outlining the more common proponent-styled rate bases, this old man of the sea must be kept in mind. The fact that we live in this world, and not in some other, and that we are dealing with existing properties, should be remembered. Some of our self-serving seers styling their preachings as "economic principle" would not only have us imagine that the gigantic engine thundering by us is not only not there but that we do not even know the location of the track on which it runs and, therefore, a sum must be allowed for reconnaissance so that we may go out and find where it is.

Problems. Base and Rate

There are two primary problems involved in rate-making, first, the rate base, and second, the rate. The solution of the first establishes the amount on which a return is to be earned. This is fundamentally a judicial function, not in the sense that judicial action constitutes a fact, but that an existing fact is to be ascertained.[29] The establishment of rates has been always primarily legislative in nature. It is judicial only in the ascertainment of whether or not the mandate of the legislature is beyond its power. In 1876 the Supreme Court thought that even abuse of legislative discretion did not call for judicial office.[30] If the fact set up by legislation, the amount that may be charged for service, precludes reasonable return or constitutional right to the creditor, then property has been confiscated. Rates should not be confused with returns as rates are the charges for the service while return is the residue after deducting from the contributions of the ratepayers the cost of rendering the service. Return is net operating income.

Making rates voices public policy to a large extent and this is inherently a discretionary legislative function. There is no discretion in this sense in finding the rate base. The community and its carriers are interdependent. In competitive industry the inability of the entrepreneur to maintain the pace may under normal play of economic forces benefit the community but, if the carriers fall, it too must stumble. Return, interest, or profits depend upon the traffic carried, how much is paid for that carriage, and how much the carriage costs. Only the future will disclose the traffic and its cost. What they will be is unknown, but in rate-making they must be predicted. The success of the experts composing the Interstate Commerce Commission has disclosed that they may be approximated with sufficient accuracy for this pur-

[29] Cf. Prestis v. Atlantic Coast Line, 1908, 211 U. S. 210.

[30] Munn v. Illinois, 1876, 94 U. S. 113. Cf. Chicago, etc. Railway v. Minnesota, 1890, 134 U. S. 418; Railroad Commission v. Chicago, Burlington & Quincy Railroad, 1922, 257 U. S. 563.

pose. All judgments are the correlation of facts interpreted through the experience of the judge. The Interstate Commerce Commission is eminently equipped for this purpose.

As rate orders are legislative acts, they will not be set aside unless abusive of discretion. As definiteness and understanding in the function increase, the range between what is too low to be fair to the creditor and what is too high to be fair to the debtor diminishes. In many cases the volume of traffic will vary with the rates, and with the changes in volume the cost of handling per unit varies. Only after the interplay is settled upon can the remainder be determined. How much this balance is, and should be, is the final step in rate-making—what is a reasonable return.[31]

Legislation

A number of states had regulatory commissions and Congress itself had considered the regulation of railroads for some time prior to the act of February 4, 1887. This act prohibited unreasonable rates, but no affirmative power was given to the Interstate Commerce Commission, which was created by the act to enforce its orders. Gradually and continuously amendments have brought the Interstate Commerce Act to its present form. While the first expression dealt with rates, the Commission had no power to fix future rates.[32] The authority of the Commission was extended from time to time in regard to rates, but no authority was given to the Commission to establish a rate base. As details were added to the rate provisions, the embarrassment of the Commission was increased because it had no rate base or valuation of the property.[33] Public hostility to the supposed excessive earnings was finding increasing expression to the extent of be-

[31] Cf. Ann Arbor Railroad Company v. United States, 281 U. S. 658.

[32] I. C. C. v. Cincinnati Railway Company, 167 U. S. 479. Cf. I. C. C. v. Alabama Midland Railway Company, 168 U. S. 144.

[33] Cf. Annual Reports, 1903, pages 26-32; 1907, pages 149, 150; 1908, pages 83, 85; 1909, page 6; 1910, page 37; 1911, pages 93 and 94; 1912, pages 70, 71.

coming a political issue. Finally Congress passed the Valuation Act, which became operative March 1, 1913.[34]

The recognition to be accorded is declared but no purpose is specified in the statute for which the valuation is to be put. The express purpose of the legislation was declared by the Senate Committee on Interstate Commerce to be to find out if the earnings of the railroads were excessive, or, as stated in the report, "value for rate-making purposes". The report of the House Committee is in accord.

In 1898 the original cost of some of the roads involved in *Smyth* v. *Ames* was more than three hundred per cent of the reproduction new cost, but as the tendency of the cost lines was to cross with the latter in ascendancy the self-serving tendency of the carriers and their relatives to embrace reproduction new as the exclusive base became evident. There was little litigation before the Supreme Court and much opportunity for the carriers to adjust their position. While even the grossly excessive original cost was still greater than reproduction new, the carriers did not shift, but this exorbitant amount was definitely denied as the exclusive rate base in the three cases shortly following *Smyth* v. *Ames*.[35] It is a far cry from the carriers' position in these cases to their contention in the *Minnesota Rate Case*,[36] and all cases since. The *Minnesota Rate Case* was, of course, not decided when the Valuation Act was in gestation. These, and the *Knoxville Case* in 1909, were practically the only valuation and rate cases for the legislators' consideration. *Smyth* v. *Ames* was an accumulation of all that went before. All that followed emphatically affirmed it. Affirmed what?

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[34] Chapter 92, 37 Stat. 701; February 28, 1920, C-91, Sect. 433, 41 Stat. 493; June 7, 1922, C-210, Sec. 1, 2, 42 Stat. 624.

[35] San Diego Land and Town Company v. National City, 1899, 174 U. S. 739; San Diego Land and Town Company v. Jasper, 1903, 189 U. S. 430; Stanislaus County v. San Joaquin, 1904, 192 U. S. 201.

[36] Minnesota Rate Case, 1913, 230 U. S. 352.

Smyth v. Ames

The Court was confronted with the argument that the railroad was entitled to rates "which will enable it at all times, not only to pay operating expenses, but also to meet the interest regularly accruing upon *all* its outstanding obligations, and justify a dividend upon all its stock; and that to prohibit it from maintaining rates or charges for transportation adequate to *all* these ends will deprive it of its property without due process of law and deny to it the equal protection of the law."[37] This contention was advanced as representing the financial sacrifice to establish the business.

This is answered by showing that the expenditures may have been imprudent, that the bonding may have been excessive, and so not representing a fair measure of the necessary financial sacrifice. The Court, seeking the cost of the property rendering the service, or as the term is used interchangeably, the cost of the service; and to find this, and having no accurate reliable record, it balances the rights of the debtor public and the creditor corporation on the fulcrum of "fair value".

The carriers were contending for the cost of their property as the base and this cost was to be measured by securities issued. They were opposed by the argument that the present cost of reproducing the property was the proper measure of that outlay. The court directs its attention to the carriers' argument and agrees that the contribution of the carriers is the basis of return. Then to ascertain the amount loaned to the public—the value of that which it employs for the convenience for the public—the Court inquires (1) what was actually spent to build the plant, (2) how much has been added to it since, (3) what securities were issued and what they are worth, (4) the present value of the physical property, and (5) working capital as evidence thereof. These were the evidentiary facts of the ultimate fact—reasonable or prudent investment. The Court treats with equal impartial-

[37] 169 U. S. 543. Italics supplied.

ity the debtor public for whose protection it primarily insists on the establishment of the rate base. To measure whether or not the debtor is paying too much interest if the amount thereof be measured as the carrier asked, it inquires how much the creditor loaned. The facts evidencing that loan are set out above. To the extent that its business will permit, the creditor is entitled to a reasonable return thereon.

The Court also had before it a rate-making policy in regard to which it directs a consideration under the contested rate to (1) probable traffic and (2) to operating expenses (the rate was fixed by the statute before it).

Recognizing that the loan is a fixed sum and the interest or return is a variable measured by (1) the rate, (2) the traffic and (3) the operating expense, the court then considers usury. This is a matter left to the rate-making body. It is one which will vary with, and as the Court says, must be measured by all of the circumstances.

Thus *Smyth* v. *Ames*, if followed, would leave only the rate-making policy to be dealt with and there could be an unconstitutional taking of property only when the interest allowed on the investment is more or less than the use of the loan is reasonably worth at the time. The rate-making aspect of *Smyth* v. *Ames* is further emphasized by the privilege extended to the rate-making body to apply to the Circuit Court for the enforcement of the contested rate, if circumstances so changed that the statutory rate would provide the creditor the compensation entitled. The product under the contested rate would not have equalled operating expense or even a reasonable return upon the lowest estimate of value, namely, reproduction new.

It must be borne in mind that the Court had considered value in many taxation cases and a number of years before this case had found that value to be the selling price of the property. The refusal of the Court to establish the same rule for valuation for rate-making purposes was to reject earning power as the measure of rate-making present fair value. It was the part of the total expenditure that could

reasonably, with fairness to both sides, the prudent or historical investment, that the Court sought. And while the original cost was too excessive and imprudent through jobbery and corruption to be taken as a base, it was, nevertheless, given first place on the Court's list. The Court recognized that there might be other evidence of the reasonable financial outlay other than those expressly enumerated. It is further evidenced that the rule of *Smyth* v. *Ames* is the prudent investment that the Court in always reaffirming that case has allowed the consideration of other elements evidentiary thereof, for example, interest during construction, going-concern value, etc. The evidentiary facts of this base were selected by the Court with a view (1) fairness to investors in a regulated business and (2) adequate service at reasonable rates. The *Smyth* v. *Ames* base is the cost or amount which could have reasonably been paid to establish the existing plant used and useful in the public service and the business. It is not the present value of the present property, nor the actual cost of the present property, nor the total contributions of investors, nor the cost of a substitute plant, nor the cost of a substitute service. It is the cost of service, which is a fact, produced through an existing plant. It includes, therefore, as part of the cost of such service, in addition to the physical plant, and as part of the capital charge, such elements as going value and working capital. The amount of going-concern value earned is a fact of history, as is the cost of construction of the physical plant. Private citizens came forward with a bag of seed and sowed it in the public service. The Court is seeking to ascertain how much thereof grew to fruition. Its conclusion is an estimate, a judgment estimate, taking into account all factors which should have weight in fixing a sum which is fair both to the lender and to the debtor community. (How else can a fact be judicially determined?)

That *Smyth* v. *Ames* was seeking to ascertain the outlay reasonably necessary to set up the present plant, and not calling for repeated revaluation, is pointed out in the Ref-

eree's opinion in the *Brooklyn Gas Case.*[38] That the cost of reproduction new is a variable is clearly recognized. It is also recognized that *Smyth* v. *Ames* requires that it be considered in fixing the rate base, but "it can not be said that there is a constitutional right to have the rates of a public service corporation based upon the estimated cost of the reproduction of its property at any particular time regardless of circumstances." The variable is to be used as a check or as an evidentiary fact in finding "the actual bona fide and prudent investment" which is the "fair value of the property" and as to which "there must be a reasonable judgment based upon a proper consideration of all relevant facts."

If the rule of *Smyth* v. *Ames* gives a right to a reconsideration of all the evidence necessary in reaching a "reasonable judgment", one not unfair to either the public or the company, at each change in the cost of reproduction new, "this would result in allowing a public service corporation to take advantage of a public calamity by increasing its rates above what would be a liberal return, not only on actual investment, but upon a normal reproduction cost, in the view that unless it could make an essentially exorbitant demand upon the public it would be deprived of its property without due process of law." "*Likewise, to base rates upon an estimated cost of reproduction far lower than the *actual bona fide and prudent* investment because of abnormally low prices would be unfair to the company." (*Italics supplied.*) In the opinion of the Referee both propositions were expressly repudiated by the cases cited.[39]

That the relevant facts which include, among others, the cost of reproduction new, are merely evidentiary of the fact in issue, the actual bona fide and prudent investment, that once established is no longer subject to doubt is the Referee's conclusion. If the corporation's history discloses it, no further pursuit thereof is necessary. If it is known for only

[38] Brooklyn Gas Case (Charles E. Hughes, Referee). P. U. R. 1918, F, 335, 347-348.

[39] Page 348.

the latter part of the corporation's history, the amount not so disclosed must be judged from the relevant facts. To the judgment amount so determined under the rule of *Smyth* v. *Ames* must be added "the actual investment since that time. There is no reason why there should be a substituted or hypothetical estimate reaching an amount virtually in excess of the actual investment."

With equal definiteness an attempt to make another of the relevant facts evidentiary of the prudent investment, namely, original cost, the rate base is rejected. The opinion is permeated with the single purpose that fairness to each party is effected in finding what prudent outlay was necessary to produce the present service. This includes, in addition to allowing the utility "credit for all the property it uses in the public service", working capital, going-concern value if any, etc., and subtraction of the amount returned through amortization. The purpose of the Supreme Court is shown in the opinion of the Referee to determine an historical fact and not to speculate in metaphysics of the future. If the latter were the situation, he must have estimated going value upon some non-existing plant seeking to acquire an imaginary volume of business in an equally conjectural period of time. Instead he deals with things that are, an existing plant presently rendering public service. He, therefore, denies the claim for an additional amount as going value to cover alleged pioneer loss, because he says that from the beginning of the enterprise the utility had not failed to earn a return equivalent to the reasonable norm in unregulated fields.[40]

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[40] Cf. Des Moines Gas Co. v. City of Des Moines, 1915, 238 U. S. 153—"Included in going value as usually reckoned is the investment necessary to organizing and establishing the business which is not embraced in the value of its actual physical property. In this case, *what may be called the inception cost of the enterprise entering into the establishment of a going concern had long since been incurred.* The present company and its predecessors had long carried on the business in the City of Des Moines, under other ordinances, and at higher rates than the ordinance in question established. For aught that appears in this record *these expenses may have been already compensated in rates charged and collected* under former ordinances. As we have said, every

LEGISLATION (CONTINUED)

The wise purpose of both the Court and the Congress was to establish a permanent figure, with fairness to each contending party, which would serve effectively sound rate-making policy—equality with administrative simplicity.

The primary difficulties which confronted the Court in 1898 were little changed in 1912, namely, the ignorance of cost and the absence of inventory of railroad property. Reasonable or prudent expenditure was the objective in each and, to avoid error and aid in judgment, certain elements were required to be weighed as evidence thereof. The original Act to Regulate Commerce provided that the railroad's annual reports show "the cost and value of the carrier's property, franchises, and equipment."

The first paragraph of the Valuation Act directs the Commission to ascertain and report the value of all carrier property. The paragraph is indexed as "cost of property; elements considered in determination." The objective set for the Commission in the first paragraph is to be ascertained through the second by finding the cost. The value or cost is ascertained by weighing together the cost of the present physical property and such other costs or expenditures reasonably necessary in addition to the physical plant to render the service given to the public.

To find the value of the physical property the Commission must weigh (1) the original cost to the date of valuation (2) the cost of reproduction new and (3) the cost of reproduction less depreciation. To be weighed with the cost of the physical plant are "other values and elements of value," other expenditures in establishing the business that may be charged as loan to the debtor community. The "original cost to date" as used in the statute means the expenditure or cash outlay throughout the history of the property, of and since its dedi-

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presumption is in favor of the legitimate exercise of the rate-making power, and it is not to be presumed without proof, that a company is under the necessity of making up *losses and expenditures incidental to the experimental stage of its business.*" A get-going cost if you please.

cation to public service, for construction and improvement, excluding amounts representing property no longer in use. Against what was actually spent, he balances what it would actually cost to build it now, namely, the present physical value or the cost of reproduction new less depreciation. With equal emphasis is required the consideration of the present value of the property (present property) whose original cost is first investigated. That is, the final value, reasonable value, or prudent investment, is to be ascertained by weighing what the property cost against what it would cost at the date of valuation to find what it should have cost.

If there are other elements of value they are to be added. These, called by the legislator "intangible values," are the reasonable expenditures of the creditor in bringing a plant to its norm of production. Going-concern value, working capital and cost of franchises are to be added. Going-concern value is included because it represents the loss incurred by the creditor in putting his money in the utility instead of putting it in unregulated enterprise. It is limited to the norm because the public does not guarantee a reasonable return. If a reasonable return were forthcoming before the norm was reached, this would mark the end of the period.[41] The constitution merely guarantees noninterference with returns less than a reasonable return. If the investor has paid his money into a business which is incapable of earning a reasonable return, he must bear the burden of his lack of business acumen. The capital necessary to operate the plant is as much a part of money advanced by the creditor as is the money advanced to build the physical plant. The expenditure necessary to acquire the privilege to engage in the business is similar. These elements have been passed upon by the Court and were recognized by the legislator.

The inquiry as to the contribution of security holders required in *Smyth* v. *Ames* is combined with the purpose of the House bill to ascertain the extent of water in railway securities in the 5th paragraph of section 19a, (b 2nd) in calling for

[41a] Appendix II.

the financial history. The purpose was to ascertain owership and not ownership. The object of the legislator as well as the judge was to ascertain the amount of the loan to public use. Each properly requires a consideration of the evidentiary facts that will aid in reaching a reasonable estimate thereof. The original cost, reproduction new, the amount and market value of securities, are not merely bogies causing naevi but are the spore from which the final single sum judgment estimate grows. In this, the rule of *Smyth* v. *Ames* is the alpha and omega of all things. Jezebel, and other legal economists, have in gratifying their desires, asserted, and still assert, that some, or none of them, constitute the rate base. If a state of facts, which as yet has never existed, should come to pass, namely, that not only are all expenditures and outlay thrifty and honest, but also are known, then reproduction new will no longer be relevant. Then too the occasion for distinction between historical cost, original cost and prudent investment will become immaterial as they approach identity and measure the cost to the investor to present the service rendered to the public. Reproduction of the service and exchange value base theories were excluded in *Smyth* v. *Ames* and rejected in the Valuation Act.[41a]

Final Value

Congress then declares that the judgment of the Commission shall finally determine the indebtedness of the community. The whole tenor of the legislative hearing is to this effect. The Act itself expressly so states. Full opportunity for hearings in order that all relevant material may be offered is required. It is true that "prima facie" is adjective to "final" but the legislature states that this is so only to avoid any possibility of unconstitutionality. The Court had declared long before *Smyth* v. *Ames* that the legislative determination was subject to judicial inquiry as to reasonableness —that legislative discretion was subject to abuse. However, the legislature does have inherent power to give evidentiary weight to various facts. The greatest finality that could be

[41a] Appendix II.

given in any event in the exercise of such power is a prima facie effect. The Court has never declared that when the reasonable value is once determined under the rule of *Smyth* v. *Ames* that this may not be treated as final or that the process must be repeated in each subsequent determination of future rates. What is a matter of history is not changed by the future and all that the Court has ever required is that the best evidence be used to reasonably protect both sides in a strenuously contested issue, the reasonable or prudent amount to date loaned by the creditor for the use of the public. The House report[42] indicates the intention of finality or that the finding of the Commission be a fixed base. "To that end the bill provides that the Commission shall continue to keep itself informed, by continuing the investigation as to all extensions and new constructions and improvements and all increases in physical value, so as to keep such official valuation up-to-date at all times." This intention is reflected in the language of the Act itself.

The Senate report[43] emphasizes this intention. If the legislature intended that the whole process be repeated at each occasion for finding the "cost", there would have been no occasion to provide for bringing to date by additions, etc. They must have intended the fixed base, for if they had intended the variable base they must have called for a new determination of "present" value and not for merely totaling "final value" or fixed base plus net additions. It was the very uncertainty, absence of knowledge of the fixed base, the cost of producing the service rendered, that precipitated the Valuation Act itself. The fixed base plus adjustments would make the extent of watered securities promptly determinable at any time and this was the legislative mind. They were informed by one of their ablest witnesses that the original process might take at least four years and intended that the work once done should not be annually repeated. With due foresight, provision is made for net additions and

[42] No. 477, H. R. 22593.
[43] No. 1290, 62nd Congress, 3rd Session.

changes. They leave this particular enumeration of the constituents thereof to the informed Commission.

The stated purpose of the Act is to establish a fixed base and give finality to the Commission's finding to the extent of the Congressional power.

Present Value

Present fair value (a fact) was used in *Smyth* v. *Ames* to indicate a weighing of all the facts which, being considered, would establish a sum fair to both sides without involving any retroactive application of any rate base theory not enforced by the state at the time of the loan. It is so treated in section 19a. The amount being fairly established is made permanent. The legislature had power to say on what terms future increases should be made and did so. Both are definite sums subject to accounting control governing maintenance through operating expenses, amortization, etc.

The word "present" is used properly in connection with both the rate base and the rate. It is properly used in connection with the rate base in establishing one of the primary evidentiary facts, namely, reproduction new less depreciation. As the object here is the value at the time of the investigation, depreciation is to be included. "Present" as of the time of the valuation calls for depreciation to ascertain the actual physical property, for without considering this element the reproduction costs would be of a different property. "Present" as used by the Court in connection with the rate base has never meant that a new base must be established for each future rate. Once properly considered in connection with the other facts required in establishing the rate base, there is no necessity of its subsequent reconsideration as its function is performed. All judicial determinations are present determinations, however ancient are the evidentiary facts considered or the ultimate fact established. "Present cost" or "present value" in connection with rate-making policy must be as of the time of each rate making. This rule was duly declared in *Smyth* v. *Ames* and often repeated since.

Smyth v. *Ames* required a consideration of the probable earning capacity under the rates prescribed.[44] This is an estimate, with the results directly affected by costs. Obviously, future costs must be predicted with present cost as a point of departure. This meaning is made clear in the *Southwestern Bell Case*. *Smyth* v. *Ames* involved rate-making policy, as well as judicial fact-finding. In the *Southwestern Bell Case* the Court said "it is impossible to ascertain what will amount to a *fair return* upon properties devoted to public service without giving consideration to the cost of labor, supplies, etc. *at the time* the investigation is made. An honest and intelligent forecast of probable future values made upon a view of all the relevant circumstances is essential. If the highly important element of present cost is wholly disregarded such a forecast becomes impossible. *Estimates for tomorrow can not ignore prices of today.*" (*Italics supplied.*) In the latter case the Court was confronted with rate-making policy and consistently with its position stated in *Smyth* v. *Ames* the present costs were necessary in estimating the probable effect of the rate in issue. One of the many important criteria in predicting that fact is the cost of labor and materials. Necessarily they must be considered. The best evidence of their future cost is their present cost projected into the future by present trends and anticipated events.

This conclusion is sustained by the decision in *United Railways and Electric Company* v. *West*.[45] In regard to the expression used by the Court therein "it is the settled rule of this court that the rate base is present value" does not mean that the value for rate-making, because of the use of the term "present value" is reproduction new. The Court goes on "* * * and it would be wholly illogical to adopt a different rule for depreciation." In connection with rate-making policy with which the Court is here presented and not

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[44] Cf. Newton v. Consolidated Gas Co. of N. Y., 1922, 258 U. S. 165. "When it became clear—that the prescribed rate had yielded no fair return for more than a year, and that this condition would most certainly continue for many months, the company was clearly entitled to relief."

[45] United Railways and Electric Company v. West, 1930, 280 U. S. 234.

with the valuation case, the Court says: "The purpose of permitting a depreciation charge is to compensate the utility for the property consumed in service, and the duty of the commission, guided by experience in rate-making, is to spread this charge fairly over the years of the life of the property." The Court is dealing primarily with rate-making policy. The depreciation dealt with by the Court is depreciation in the sense of amortization. The rate base, the amount of the loan, which is to be repaid through amortization charges is the base measured by original cost as well as other elements.[46] It would be clandestine to measure the amount of the loan by one standard, and to repay it by a different one. This is expressed by the Court: "The utility is entitled to see that from earnings the value of the property invested is kept unimpaired, so that at the end of any given term of years the original investment remains as it was at the beginning." Present value is used in the same sense here that it was in all other cases under and since *Smyth* v. *Ames*. In so far as the Court uses depreciation as meaning charges for current maintenance, obviously replacement must be at current prices or present value. It should also be noted that the manner in which the value subject to amortization charges against operating expenses is raised in the record, the presently agreed valuation is equivalent for the purpose to a determination thereof under the rule of *Smyth* v. *Ames*. To test the reasonableness of the anticipated return as a matter of rate-making policy, it was necessary to consider the present cost of labor, materials, etc. in order to estimate their effect upon such return.

Rate-Making Policy. Section 15a

If the cost of paving Avenue A in the year X is 100, and of similar work on Avenue B in the following year is 110, the A taxpayers could not be compelled to pay interest on the B costs, nor could the B taxpayers complain of discrimination. If the town C can build a local utility plant for 100, the fact

[46] Deductions for salvage values, and working capital, etc., are proper.

that a similar plant in D cost 200, does not require rates in C to pay a reasonable return on 200. Interstate railroads are not local in aspect but connect many cities and states in continuous systems. Therefore, regardless of certain differences of cost in producing the service rendered between two competing carriers, the rates of each must be substantially equal. Thus reasonable return on the prudent investment, treating each interstate carrier *separately,* is automatically eliminated from any rate-making policy contemplated to sustain all carriers in an adequate system of transportation. A number of possibilities were open to the legislator. He might have refrained from any regulation and control. He might have declared that all carriers be entitled to a reasonable return and treat each carrier separately in fixing reasonable rates therefor. He might have dealt piece-meal with competing groups and declared that rates be the same on each but high enough to yield a reasonable return on the least favorably situated carrier. There were other possibilities and combinations of possibilities. In either of the two first above mentioned somewhat similar consequences might have followed If wholly unregulated, the result would have been a cut-throat competition for survivorship of the most advantageously located road. In some parts of the United States there are three or four or five carriers serving the same territory. One or more of these may be so advantageously located that with the volume of traffic and its cost of operating a rate which will produce at least a reasonable return to it will exterminate its competitor. The second possibility might even exaggerate this situation and hasten the execution because the advantageously situated carrier might with no regulation charge rates higher than necessary to produce a reasonable return on its own property and thus publish a rate tending to approach one high enough to allow a liquid diet to its weaker fellows. Under regulation which merely reduced the advantageously situated carrier's rate so that it might earn only a reasonable return the weaker carrier might not be fed at all. On the other hand, if the cost to build its

plant and render service was much greater than the cost to the less advantageously situated carriers, this would not necessarily follow. If the legislature treated the transportation system piece-meal in competing groups and fixed minimum rates so as to protect the weakest competitor, then the advantageously situated carrier would automatically therewith receive a return vastly in excess of its constitutional right. Assuming that the (community) shipper did not object,[47] then the legislature might have ignored this excessive return or provided for its disposition.

Congress wisely foresaw and understood these possibilities and adopted a plan more comprehensive than any of those just suggested. It recognized that each interstate carrier is not and can not be regulated without considering its relation to others—that each carrier is a unit in a public service, national in scope, and in so doing sought to build up a *system* of railways competent to handle all the interstate traffic of the nation. Its wisdom and foresight found expression in the rate-making policy of the Transportation Act.[48] Some of these provisions were novel in legislative expression and comprehensive in their object. In the language of the Supreme Court "the new act seeks affirmatively to build up a system of railways prepared to handle promptly all the interstate traffic of the country".

In regard to rate-making policy the legislator recognized that the first step under comprehensive regulation and control in the interest of commerce was to establish uniform rates adequate to sustain all interstate carriers indispensable to the communities served. Secondly, he recognized that this would necessarily stultify advantageously situated carriers in providing them with a net railway operating income substantially and unreasonably in excess of a fair return upon

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[47] Cf. Brooklyn Union Gas Co. v. City of New York, 1907, 188 N. Y. 344; St. Paul Book Company v. St. Paul Gas Light Company, 1915, 130 Minn. 71; Dayton Goose Creek Railway Company v. The United States, 1924, 263 U. S. U. S. 456 at 480.

[48] February 28, 1920, C-91, Sec. 422, 41 Stat. 488.

the value of their property held for and used in the service of transportation. Having declared a rate-making policy which resulted in a charge to the debtor, consumer, shipper, using the advantageously situated carrier, which was *usurious*, the legislator had several alternatives. The excess income might have been impounded in the hands of the carrier under regulations requiring it to be held as a reserve to be drawn upon during such periods as the net railway operating income might be, and to the extent, less than a reasonable return upon the fair value of its transportation property. Such a policy would not, except for the initial step, have gone far toward the objective of establishing an adequate national system. No public service operator has a right to more than a reasonable return. This can be accomplished in the case of the individual carrier by merely establishing a rate which will provide the same. The application of a uniform rate to the national system would necessarily result in some units thereof receiving more. As the carrier in any event has a property interest protected in a constitutional sense in a reasonable return, it is immaterial whether the regulatory action comes before or after the operation. Thus, if more is produced in combining operating expenses, traffic, and rates than a reasonable return, the usurious excess is not the property of the utility. Where this excess is obtained in contemplation of an existing statute providing for its disposition, the carrier may not complain of confiscation because the excess was never its property.

It was in regard to the second phase of rate-making that the constructive statements of Congress are expressed in paragraph 422 of the Transportation Act.* This provision, the now famous paragraph 15a of the Interstate Commerce Act, provides for a revolving fund fed by the excess earnings of fortunately situated carriers which under the supervision of the Interstate Commerce Commission is made available to the needs of the less prosperous units of the transportation system of the United States. Congress recognized that it is a national legislature and that the community to be served

*Appendix I.

by the properties devoted to interstate transportation is the United States. It accomplished this through the recapture provision of section 15a referred to by the Supreme Court as "the key provision of the whole plan". The plan being a reasonable one, there was no abuse of the discretion in exercising an inherently legislative function.

So far we have contemplated only aspects of section 15a the function of which is, in so far at least as the recapture provision is concerned, to produce excess income. But before there can be any excess income, the carrier must have earned a reasonable return upon the fair value of its property. Therefore, the legislative policy in regard to, first, the amount on which is to be measured the return and, secondly, what is a reasonable return are the fundamental issues in interpreting the several paragraphs of section 15a. What does the legislator declare to be the rate base and what is the maximum return that it permits thereon before any part thereof is subject to recapture?

Reasonable Return. Section 15a

Before taking up the question of any excess earning the Transportation Act looks, as the first step in assuring an adequate national transportation system, to the immediate needs of the earning carriers. It gave for the first time affirmative power to the Commission to establish both maximum and minimum rates, as well as control over joint, through, division of rates, etc. This was an essential step in effecting the legislative objective.[49] Prior to the Transportation Act the Com-

[49] "Congress steadfastly withheld from the Commission power to prevent by direct action the charging of unreasonably low rates. The common law did not recognize that the rate of a common carrier might be so low as to constitute a wrong; and Congress has declined to declare such a rule. Despite the original Act to Regulate Commerce and all amendments, railroads still have the power to fix rates as low as they choose and to reduce rates when they choose. The Commission's power over them in this respect extends no further than to discourage the making of unduly low rates by applying deterrents. One such deterrent is found in the fact that low rates, because voluntarily established by the carrier, may be accepted by the Commission as evidence that other rates, actual or proposed, for comparable service are

mission was like the unskilled traffic policeman whose time is devoted to gesticulating about traffic violations and who succeeds through "don'ts" and censure in giving little aid to transportation. Under the provisions of the Transportation Act the Commission was given the power and duty to *aid* transportation. From the earliest date the Interstate Commerce Act had prohibited unjust and unreasonable rates, but not until 1920 did Congress announce a rate-making policy including a Commission-duty to establish reasonable and just rates with the view to leaving a profit balance after deducting expenses from the product of the rates under economical and efficient management. If the balance is reasonable, the rates are just. Anything less, always assuming harmonious business conditions, fails to provide food for maintenance and healthy growth. This fundamental essential was recognized by the legislature—power to attract capital.[50] As new capital is forthcoming only from non-governmental sources without compulsion, only a rate which will give railroad securities magnetism for private funds makes governmental regulation of privately owned utilities justifiable. New capital is forthcoming when its owner is assured of, first, the safety of his principal and, second, a constant return as great as the market norm. As the certainty of each is increased, the cost of the loan, or the second element, decreases. Without giving managerial authority, the accomplishment of this purpose

[50] 66th Congress, 1st Session, Senate Report No. 304.

unreasonably high. The voluntary making of unremuneratively low rates in important traffic may also tend to induce the Commission to resist appeals of carriers for general rate increases on the ground of the financial necessities. But the main source of the Commission's influence to prevent excessively low rates lies in its power to prevent unjust discrimination. The order prohibiting the unjust discrimination, however, leaves the carrier free to continue the lower rate; the compulsion being that if the low rate is retained, the rate applicable to the locality or article discriminated against must be reduced. That is, the carrier may remove the discrimination either by raising the lower rate to the relative level of the higher, or by lowering the higher to the relative level of the lower, or by equalizing conditions through fixing rates at some intermediate point. Skinner and Eddy Corporation v. The United States, 1919, 249 U. S. 557, 565-566.

was placed under the fostering guardianship and control of a body appointed by law and informed by experience, as was suggested by the Court in *Smyth* v. *Ames,* best able to deal with the undertaking, namely, the Interstate Commerce Commission. The choice of agency was fortunate, for the solution for this colossal economic problem affects directly every resident of America. And, as the legislator said: "No other official body in our government stands higher in the estimation of the people. Its integrity, nonpartisanship, and fearlessness in the performance of its duties can not be questioned."[51]

There are two phases of this commission mandatary. We must recall that the Transportation Act deals with many problems.[52] Certainly not the least important of these was the return of the railroads to private control. It became effective at a time of great social, political and economic unrest, when nothing was safe but democracy. With the determination of governmental insurance of income as of either March or September 1, 1920, stability of this economic framework was possible only by fixing a return in the enjoyment of which the carriers were free from interference. A return was set up which in the opinion of the legislator was at least equal to the amount to which the carrier was entitled as a matter of constitutional right. This was the first phase above referred to. Thus, for the first two years beginning March 1, 1920, the carriers were given by the legislature a return of not less than five and one-half per cent and not more than six per cent. The minimum was fixed by paragraph 3 of section 15a, the maximum by paragraph 6 of this section.[53]

In the only case in which the constitutionality of the return fixing has been tested before the Supreme Court a peculiar

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[51] 66th Congress. 1st Session, House Report No. 456.

[52] (1) Rate-making, under Section 15a.
(2) Recapture under section 15a.
(3) In prescribing division of joint rates under section 15.
(4) In determining the limit upon the amount of capitalization in event of consolidation under section 5.
(5) In determining the propriety of an issue of securities under section 20.

[53] Amounts over 6% might be subject to the recapture provisions.

situation existed which may be common to many other carriers varying in degree, of course, to the extent of watered securities outstanding. The return either fixed by the Congress for the first two years, or as thereafter determined by the Commission, is a percentage of the aggregate property value used in public service. Therefore, a stated percentage, for example 6 per cent, might render a much higher rate to security holders. In the *Dayton Goose Creek Case* the situation was somewhat the reverse of this. There the earnings were so large that even after deducting half the excess over six per cent a return of eight per cent on the reported value remained and this was thought not confiscatory.

This brings us to the above mentioned second phase of the return measuring features of Section 422 of the Transportation Act. The transition from the first to the second phase of the rate-making policy can be better understood by studying its travail. The Transportation Act fixed a minimum return by statute but it was emergency legislation with a stated maximum duration. There was strong advocacy in the House to legislatively declare reasonable income without the emergency aspect. Against this the House Committee on Interstate Commerce definitely and wisely set themselves.[54] They fully recognized the inability of one Congress to bind its successor and that legislative declaration of reasonable return, if for no other reason, was highly undesirable because instability of rate structure would result. To escape this the problem was delegated to the Commission whose impartiality was never impeached. The House bill continued the existing law authorizing the Commission to prescribe just and reasonable rates. The Senate bill produced the minimum reasonable return and fixed the duration of the emergency period. The minimum so fixed was more than was thought necessary to produce a reasonable return if conditions remained unchanged but the owners were being repossessed of their lines when conditions were unsettled and abnormal and suspicion and distrust was everywhere. To give confidence and sta-

[54] House Report No. 456, 66th Congress, 1st Session.

bility a rate of return over the pre-war period return was thought appropriate.

This discussion has been leading up to the question as to whether or not the six per cent provision of section 15a is a permanent maximum figure. It is postulated that it is not. We have already seen that the House rejected a statutory declaration of future reasonable return. It also contained other elaborate classification percentages of excess income and provision for their disposition and control. The primary aspect, however, of the Senate bill was the fixed minimum return of five and one-half per cent. One of the reasons for the allowance of the minimum return in excess of the pre-war period was the inflated condition of money. The possibility of price adjustments was tied to the five and one-half per cent provision, as well as to the maximum return provision. The Commission was, at stated periods of five years, "to determine what, under the conditions then existing constitutes a fair return upon the value of such railway property, and it may increase or decrease the five percentum basis herein prescribed or the basis for the determination of excess income." That six per cent was not a permanent figure in this bill is so declared by the bill itself, as well as by the purpose sought to be accomplished. These provisions and intent were integrated into section 422.

Paragraph 2 directs the Commission to enact, prescribe, modify, establish or adjust reasonable rates so that carriers may earn an annual net railway operating income equal, as nearly as may be, to a fair return upon the aggregate value of their railway property held for and used in the service of transportation. In this paragraph are combined the reasonable rate provisions of the House bill, together with the Senate's fair return on aggregate values. We must look further for the meaning of fair return. Paragraph 3 defines fair return as a percentage of aggregate value to be determined by the Commission from time to time. There is no legislative expression of percentage or period. These were left to the Commission. The only mention of maximum and

minimum percentages and period are included in the temporary provision establishing such for the emergency period of two years. Thereafter both time and maximum and minimum percentages of value for future periods of reasonable return are left to the Commission.

The integration of the above quoted provisions of the Senate bill continues in the subsequent paragraphs of section 15a. Paragraph 5 introduces the recapture provision and its justification. The standard of paragraph 3 is made the measure of the excess income. Excess income is the amount received by the carrier over a fair return. Fair return is, under paragraph 3, a determination to be made by the Commission. If section 6 stood alone, establishment of our postulate might seem doubtful. If we read it—"if * * * any carrier receives for any year a net railway operating income in excess of 6 percentum of the value of the railway property * * * one-half of such excess shall be placed in a reserve fund"—it seems no less permanent than a candidate's position on the prohibition issue—announced immutability. It does not stand alone, but stands as part and parcel of the whole section and is to be interpreted with it. We must remember also that this is the old Senate provision revised to meet the House position. Under paragraph 3 the duty to determine and announce the percentage of value that constitutes a fair return is imposed upon the Commission. Section 9 personifies this duty in directing the Commission to make proper adjustments to provide for the computation of excess income for a year in which a change in the percentage constituting a fair return becomes effective. If any aid were necessary in concluding that six per cent is not an unchangeable maximum under the terms of the Act itself, and I believe it is not, an interpretation given by the legislator would be conclusive. We have only seen that there was no doubt as to the senatorial intention. The Senate bill was integrated with the House bill to produce section 15a. It would thus seem that if the House Committee believed the purpose of the Senate bill was perpetuated in the Conference

bill, the legislator's interpretation is established. The conference report states: "The result of these provisions is that the five and one-half per cent is fixed as a minimum and six per cent as a maximum during the next two years, and *thereafter the matter is left to the discretion of the commission.*" (*Italics supplied.*)

Six per cent in paragraph 6 is merely a point of departure. If pursuant to paragraph 3 the Commission should find the percentage of value to be six and one-half per cent, no amount less than six and one half per cent so calculated would be subject to recapture. Thus, if six and one half per cent were found by the Commission to be the percentage of aggregate value of the railway property held for and used in the service of transportation that constitutes a fair return, then only net railway operating income in excess of six and one-half per cent of such value would be subject to recapture. The converse of this seems equally clear—that since the five and one half and six per cent provisions of the original act were emergency legislation and that "thereafter the matter is left to the discretion of the commission" that the Commission can declare all amounts over the percentage declared pursuant to paragraph 3 as subject to the recapture provisions. The Commission has never found, and there is no immediate possibility that it will find, the percentage under paragraph 3 greater than six per cent. The uniform practice has been, and is, regardless of the paragraph 3 percentage, to treat only such return as exceeds the six per cent of paragraph 6 as subject to recapture.

What percentage of the aggregate value of the railway property should the Commission declare to be a fair return?

Reasonable Return

The legislative history of the Transportation Act shows that the draftsmen of section 422 recognized the true base on which governmental regulation of privately owned utilities must rest. Foremost is a system that can be effectively administered with simplicity and economy. Standards must be

established to effect financial stability. Financial stability depends upon assurance that existing property will be protected plus the capacity to attract additional capital. The safer the principal and the more certain a uniform return, the more readily new capital will be forthcoming in diminishing costs.[55] To give the most efficient service at the lowest rate fair to the producer necessitates a large and constant inflow of capital. The lowest rate charges to both the debtor and creditor must provide a fair return under honest, efficient and economical management over and above reasonable expenditures of maintenance of way, structures and equipment. If this is true, private capital will be readily forthcoming. If the inflow is so great as to deflect capital from other fields in amounts more than are necessary for utility stability, rates are too high.

Value is merely an expression of a relationship between various economic interests used to describe that relationship in regard to various property concepts. This relationship or value is generally expressed and determined in terms of money, but money is merely the medium of exchange described in dollars. Valuation for rate-making is analogous only to a limited extent to valuation in condemnation proceedings. In all properties embraced with the public interest subject to regulation by the state the time at which value is to be determined for rate-making purposes is the time at which the properties are devoted to the public service. The reasonable outlay of money which he might have devoted to some other enterprise constitutes that value. The owner of such properties is entitled to a reasonable return upon the fair value of his property. The primary purpose and ultimate object in establishing value for rate-making purposes is to establish a base on which to measure a return or income that the owner

[55] "Acting Secretary Mills announced yesterday subscriptions of $200,798,000 had been received for tenders of $60,000,000 of 91-day Treasury bills offered August 3. The bills were dated August 10 and mature November 9. The highest bid made was 99.878, equivalent of an interest rate of about 0.48 per cent annually, and the lowest 99.846, equivalent of an interest rate of 0.61." Associated Press 9/7/31.

is entitled to. The obligation of the state in condemnation proceedings is to compensate the owner for the full value of his property contemporaneously with the taking for what he has lost and not what the taker has gained. Value in condemnation when determined is settled once and for all. In the determination of that value the particular use to the government is not a criterion. The owner must be compensated for what has been taken from him, but that is done when he is paid its fair market value for all available uses and purposes. In *Omaha* v. *Omaha Water Company*,[56] a condemnation case, the Court said, "both cases were rate cases and did not concern the ascertainment of value under contracts of sale." In the ordinary debtor and creditor relationship the duty of the debtor is to pay a specific number of dollars some time in the future.[57] The obligation of the debtor in valuation proceedings is to compensate the creditor for the value of his property as of the time of its devotion to public service. The determination of the base alone does not establish whether or not the constitutional rights of the owner have been recognized. It is a question of fact in every case as to whether or not his return on the value of his property devoted to the public service is reasonable. The Constitution precludes the taking of private property for public use without just compensation. If the test of value was sale or exchange, then clearly any reduction of the return or income would necessarily constitute a taking of property. In all valuation proceedings we are confronted by a situation in which the state, limited by the provisions of the Constitution in regard to private property, is regulating privately owned property which is devoted to a public service. The obligation of the debtor community or state as distinguished from the ordinary debtor-creditor relationship is not to pay a fixed sum or number of dollars in the future but to protect or assure the owner of the property from unreasonable taking

[56] 218 U. S. 180, 203.

[57] Cf. Hicks v. Guiness, 1925, 269 U. S. 71.

and at the same time to recognize the right of the community or debtor to be served at a reasonable rate. There is no constitutional right of the owner of property devoted to a public service to earn more than a reasonable return upon the fair value of his properties. Correlatively expressed, the owner of such property is under a duty to provide the service rendered at a reasonable rate. He is not entitled, as in competitive fields with unregulated properties, to a return measured by what traffic will bear. At the same time he is protected through the duty imposed upon the rate-fixing bodies to a return which will provide, to the extent that the traffic will sustain the burden, to a reasonable return on that value. The great difficulty in valuation proceedings is to divorce the public mind from the popular concept of the debtor-creditor relationship to pay in the future a certain sum measured in terms of dollars. The rate-fixing body, representing both the debtor and creditor in the peculiar relationship involved in all valuation proceedings, must perform its duties to both parties impartially. If public service is to be rendered, as it is and will continue to be, by the devotion of private capital to such enterprises, any method of valuation or rate-making which fails to provide a return which will induce private capital to enter the field of public service fails to discharge the duty of the rate-fixing body to each party. If capital devoted to public purposes can not be assured of a return equivalent to that obtainable in services other than those impressed with public interest, funds for their financing must be forthcoming from other sources. It is undoubtedly true that the public thinks of value in terms of exchange price or of the debtor-creditor relationship with payment of a sum in the future. The difficulty of this concept is increased by thinking of value in terms of our own monetary standards. If money were described in terms of marks, or rubles, or francs, the fact that money is merely a term to describe a relationship, all valuation for rate-making would be more comprehensible. Income describes the return to the owner of property used by others. Income may be described

in terms of monetary standard or in terms of satisfaction, in the sense that income constitutes the source of human want satisfiers. If, for example, we had a black bag filled with money, knowing only that it contains money, but not the number of dollars, lire, lei, rupees, piestres, the denominations in which it might be described, the value of that money could only at any particular time be measured by its capacity to provide the owner with the satisfaction of human wants and not by whether, if devoted to the use of others, that inflow could be measured, for example, by $1,000. In other words, the value of that money to him is measured by what it will supply him with. If marooned alone on an island, it would be of no value to him. If a member of society, the return that $1,000 provides depends upon the extent of inflation. The value of this bag full of money to its owner is not the $10,000 which it contains, or the $1,000 which it will produce, but the satisfaction it produces in the sense that a means is provided of satisfying his wants. The constitutional obligation, if it may be so expressed, of the rate-making body, is to provide a rate to the owner of such properties which will be equivalent to the return which the money invested would produce to him if invested in other available business opportunities. (The importance to the owner of the valuation of the property as compared with the income therefrom varies in about the ratio of 1 to 16.) Therefore, if the fixed base is established by the consideration of all of the elements required by the Supreme Court in *Smyth* v. *Ames,* there is established for all times for the purpose of rate-making the sum on which the investor is entitled to a return and the reasonableness of that return is to be measured by the buying power or want-satisfying capacity of a similar sum devoted to other available enterprises at any particular time. The reasonable cost of the existing properties is their value for rate-making—the amount loaned to the use of the community. As the valuation is the basis of return, any given percentage of the rate base may, and often does, produce a higher return to the outstanding securities varying, of course, to the extent the securities are

watered. If capitalization is sound, the amount of outstanding securities tends to represent in general the dollars invested.

The return should be sufficient to pay liberal dividends and leave a surplus above. This does not mean dividends upon watered securities. The language of the court in *Ames* v. *The Union Pacific,* is appropriate in this respect. "If it be said that the rates must be such as to secure to the owner a reasonable profit on the money invested, it must be remembered that many things have happened to make the investment (expenditures) far in excess of the actual value of the property—injudicious contracts, poor engineering, unusually high cost of material, rascality on the part of those engaged in the construction or management of the property. These and many other things, as is well known, are factors that have largely entered into investments (expenditures) with which many railroad properties stand charged." The Supreme Court balanced the right to a return against the worth of the services rendered.

Thus was committed to the rate-making body the duty to use their information and experience in predicting future earnings and to leave, in excess of cost of rendering the service, dividends plus. The costs are a prediction derived from trends with present costs as a point of departure. They include the prices of the material and labor consumed in current operation. These include expenditures for maintenance of way, structures, and equipment. In making such determination the Commission must give due consideration to the transportation needs of the country and the necessity of enlarging the facilities so as to provide an adequate system. From the earliest time the Court's objective has been reasonable or prudent expenditure both as to construction and operation. *Smyth* v. *Ames* included both, and they are repeated in sections 19a and 15a. In *Chicago & Grand Trunk Railway Company* v. *Wellman,*[58] the Court says in regard to current expenditures, "surely before the courts are called upon to ad-

[58] 1892, 143 U. S. 339.

judge an act of the legislature fixing the maximum * * * rates for railroad companies to be unconstitutional, on the ground that its enforcement would prevent the stockholders from receiving any dividends on their investments, or the bondholders any interest on their loans, they should be fully advised as to what is done with the receipts and earnings of the company; for if so advised, it might clearly appear that a *prudent and honest management would,* within the rates prescribed, secure to the bondholders their interest, and to the shareholders reasonable dividends. While the protection of vested rights of property is a supreme duty of the courts, it has not come to this, that the legislative power rest subservient to the discretion of any railroad corporation which may, by exorbitant and unreasonable salaries, or in some other improper way, transfer the earnings into what it pleased to call operating expenses." (*Italics supplied.*) The "honest, efficient and economical management" admonition often appears in section 15a and applies to plant additions, as well as to current operating costs. Attracting capital and the reasonable worth of the services involves stocks, as well as bonds, for unpreferred as well as preferred securities are necessary for the maintenance and extension of the enterprises.

Before pursuing further factors which must be considered by the rate-making body in determining what percentage of value constitutes a fair return thereon, we must take up the question, so far avoided, what is value under 15a? Before passing, however, we should note that bonds now represent at least two thirds of the outstanding securities. Their amount reflects to some extent a capitalization of earnings. The rate of capitalization on these is undoubtedly much lower than the rate that would apply to the remaining one third. This percentage in all, or nearly all, cases gives security to the principal advanced and the interest is assured through past experience and future possibilities by fixed preference contract provisions. The high percentage of bonds reflects the virtue of stabilizing both the base and the return.

There are two ways in which the rate-making process may violate the property owner's constitutional right.[59] The first is to take part of the property (base) without compensation. The second is to take the use of such property without just compensation. It is the latter that we are here concerned with. The distinction between the two is that when the first has once been determined pursuant to *Smyth* v. *Ames* it is permanently established. To the extent of changed conditions no former conclusion of reasonable return controls present determination. The problem is one to be tested primarily by present-day conditions. A reasonable return proper a few years ago no longer furnishes a safe criterion either for the present or future in the same, or in other, types of utilities. The amount depends upon circumstances, locality and risk. In the *Baltimore Railway Case,* the Court summarizes the problem.

"What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally.

"Investors take into account the results of past operations especially in recent years, when determining the terms

[59] Cf. Kansas City R. R. Co. v. U. S., 1913, 231 U. S. 423, 445.

under which they will invest in such an undertaking. Low, uncertain and irregular income makes for low prices for the securities of the utility and higher rates of interest to be demanded by investors. The fact that the company may not insist as a matter of constitutional right that past losses be made up by returns to be applied in the present and future tends to secure credit, and the fact that the utility is protected against being compelled to serve for confiscatory rates tends to support it. * * *"

"What will constitute a fair return in a given case is not capable of exact mathematical demonstration. It is a matter more or less of approximation about which conclusions may differ. The court in the discharge of its constitutional duty on the issue of confiscation must determine the amount to the best of its ability in the exercise of a fair enlightened and independent judgment as to both law and facts.

"It is manifest that just compensation for a utility, requiring for efficient public service sacrifice and prudent management as well as use of the plant, and whose returns are subject to public regulation, is more than current interest on mere investment. Sound business management requires that after paying all expenses of operation, setting aside the necessary sums for depreciation, payment of interest and reasonable dividends, there should still remain something to be passed to the surplus account; and the rate of return which does not admit of that being done is not sufficient to assure confidence in the financial soundness of the utility to maintain its credit and enable it to raise money necessary for the proper discharge of its public duties."

Present values are vital to accurate prediction of future costs which must be deducted from the product of rates as well as for present application. Reasonable return and rates are bound inseparably together. This was recognized by Congress and expressed in section 15a. The Commission must from time to time and as often as necessary declare what is a reasonable return, and a rate most likely to produce the same. This does not call for devastating frequency because the adjustment afforded in the recapture provision makes possible a constructive rate-making policy and eliminates frequent rate changes.

Value Under Section 15a

We have traced the judicial requirements to ascertain the ultimate fact of reasonable or prudent expenditure to produce the services rendered in regard to that part of the carrier's history when no accurate records were kept. With the keeping of records subject to appropriate accounting regulations these requirements may be found in regard to net additions and betterments without external evidence of cost. Section 19a accepted these standards and directed the Commission to ascertain the amount. It also directed that the determination should be conclusive of subsequent inquiry. Paragraph 2 of section 15a refers to "fair return upon the aggregate value of the railway property of such carriers held for and used in the service of transportation"; this is repeated by reference in paragraphs 3, 5, 6, 7, 8 and 9. This language is similar to the language of section 19a but the property to be treated is limited by 15a to property used and useful in the public service, while 19a, for very good reasons, required a valuation of noncarrier as well as carrier property. As 15a is devoted to rate-making, all noncarrier property was necessarily excluded. A 1913 Congress declared that the value found under section 19a be final for all purposes of the Interstate Commerce Commission. Congress in 1913 could not bind Congress in 1920. Our interest is, in this instance, the latter legislative intention and the expression of intention of the legislator and the statute itself are the best evidence thereof.

In regard to consolidation the Senate Committee says:[60] "The distinctive feature * * * is that the capitalization is not to exceed the actual value of the property held for or used in the transportation service. One of the chief causes leading to the public distrust of railroad financing is the deep conviction on the part of the people that the past capitalization of many of the railways grossly exceeds the real value of the property which renders the service. When the Interstate

[60] Report 304.

Commerce Commission finishes the valuation in which it is now engaged and when those valuations, as they are judicially determined, and only those values, pass into the capitalization of the newly organized or reorganized corporations under this act, that serious obstacle in the way of effective regulation will have disappeared."

Unless actual value or the value under section 19a is a fixed, and not a fluctuating one, any change in the base might make the capitalization as heavily watered on a shrinkage base, unless a shrinking process were contemplated for the outstanding securities, as was the result without that final determination. No plan of shrinking securities was provided. This is further emphasized in the enumeration of the results to be accomplished:

"First. By prescribing a basis of return upon value of railroad property, to give such assurance to investors as will incline them to look with favor upon railroad securities; that is to say, by making a moderate return reasonably certain to establish credit for the carriers.

"Second. In making the return fairly certain to secure for the public a lower capital charge than would otherwise be necessary."

The report, as previously shown, indicates that these objectives require stability of principal and stability of interest. The base is established by adoption of the principles of section 19a. The report continues:

"It is the duty of the government so to exercise its power of regulating commerce among the states * * * that all parts of a common country shall enjoy adequate transportation facilities at the lowest cost consistent with fairness to the capital invested and to the men who manage and operate these facilities."

The "invested capital" refers to the determination under section 19a.

This intention is given unequivocal expression in the language of section 15a. The expressed intention in 19a to make the valuation determined thereunder conclusive in all subse-

quent valuation issues is perpetuated in section 15a: "Whenever pursuant to section 19a * * * the value of the railway property of any carrier * * * has been finally ascertained, the value so ascertained shall be deemed * * * to be the value thereof for the purpose of determining such * * * value" under section 15a.[61] No possible doubt can exist as to the proper interpretation of this language. In order to comply with paragraphs 5 and 6 it is essential that the amount of the loan to date be determined. The Commission is directed for this purpose to determine from time to time and as often as may be necessary what this amount is. This direction is proper, but unnecessary. Section 19a gives this duty and authority and the above indicated paragraphs of section 15a make it essential to their enforcement.

It must be remembered that in February, 1920, when the language of 15a became statutory, no valuation under section 19a was final. In fact, up to July, 1920, underlying reports were available for only fifteen and one-half per cent of the total mileage; 1,000 miles were not even inventoried as late as December, 1920; and only 55 tentative reports had been issued in November, 1920. Although no final valuation was available for the purposes of section 15a at the time of its enactment, the years of endeavor pursuant to section 19a had made available a tremendous volume of data. As no final value was available and the recapture provisions were to be made immediately effective, valuation work had to be expedited. All the data necessary under section 19a need not be included in valuation under 15a. Section 15a, involving rate-making and return, dealt only with railway property held for and used in the service of transportation. Therefore, Congress authorized the Commission to utilize the result of its investigation under section 19a. In so far as deemed available in determining such value, the Congress directs that "the Commission shall give due consideration to all the elements of value recognized by the law of the land for rate-making purposes." The elements of value are the same elements

[61] Sec. 15a, paragraph 4 (Appendix I).

of value as under section 19a. The objective is the same in each statute. The intention of the former act is reflected in the latter. The results under the former, when final, are made conclusive under the latter. Clearly a different base was not intended for recapture purposes. Unless the contrary be true, then the ultimate fact, prudent investment, is to be established by the same evidentiary facts under section 15a as under 19a and in accordance with the prior declarations of the Court. This interpretation is emphasized by giving "to the property investment account of the carriers only that consideration which * * * it is entitled to in establishing values for rate-making purposes under the law of the land." These provisions were integrated from the House and Senate bills and a violent effort to establish the investment account as a rate base for recapture. The House bill had no recapture provision and contemplated no change in existing law and so affirmatively indicated.[62] With this background the bill expressly denies weight to any element not previously recognized in American valuation law.

Congress thus committed to the Commission the task of ascertaining the prudent investment reasonably necessary to produce the service rendered in fact, the determination of what percentage thereof constitutes a fair return, and the prescription of rates adequate to produce such return. The first, when finally determined, need only be adjusted from time to time. Some time has already been devoted to the discussion of the second. It is clear from the language of section 15a that this percentage is to be declared periodically and, within such periods, is to be uniform both horizontally and vertically. The declaration of the period is in the discretion of the Commission and depends upon circumstances.[63] The improvement of credit, stabilization of base and rate, the availability of cheap new capital were foremost in legislative objective. While a permanent fixed standard was prescribed

[62] Cf. Sections 417, 429.

[63] Cf. paragraphs 2, 3, 9, section 15a.

for the base,[64] as has been shown above, declaration of permanent rate was carefully avoided. The legislator recognized that a uniform number of dollars in return did not produce the desired stability. Both branches of Congress recognized this. If we applied a permanent rate to a fixed base, security holders would be at the mercy of price cycles. But we must consider what our bag of money, the rate base, would bring, if available to the lender for investment in other enterprises, and only by such barometric readings can credit stability be established and speculation and water be excluded from non-preference, unfixed, income securities. The Senate report sets out as one of the reasons for section 15a that money was less valuable than in a few years past and that "it would seem to be only fair that the returns from railway investments should be reasonably advanced". Further, the rate was fixed by the emergency period higher than was thought necessary for a reasonable return. The high emergency rate, however, was not allowed to produce excessive return as it was made subject to adjustment under the recapture provisions.

Stability of return is established by ascertaining what the dollars in loan would produce under current conditions measured by commodity prices. Stability of rates may be approached by a liberal initial rate with subsequent adjustment through recapture. Ultimately, recapture is only rate adjustment. All future facts are more or less uncertain. Predictability may improve as past and present fluctuations minimize. As it does, the importance of the backsight aspect in rate-making of the recapture provisions decreases. Fixed income securities are not affected. They continue to have the characteristics which first made them attractive, namely, the contract price in dollars in consideration for the use of the money lent. Unfixed income, non-preference, securities acquire the virtues of the former as under the statute they are entitled to a uniform reasonable return. Some will say that income stabilized in terms of buying power will not make

[64] Cf. State v. Dept. of Public Works, 1927, 143 Wash. 67, 254 Pac. 839.

cheap capital available through shares and that is shown by the fact that at least two-thirds of the present securities are stabilized by contract in dollars. But these were issued when the only assurance of any approach to stability of income that was available was represented by bonds—the shares were for the risk-taker. Even under stabilization the bond-cultured palate of the investing public may constitute a quicker market for the old favorite, but whether or not this may be true, as certainty of income increases, the rate of capitalization on the remaining will certainly decrease.

One of the reasons why a fixed base is not productive of stabilized return under the various theories is that it is multiplied by a return in terms of dollars. This is avoided under the adjustment to real income contemplated by section 15a. For the same reason, the attack by the same group on prudent investment is inapplicable to the Federal base and rate policy. Even if the service could be replaced for much less, no greater public hostility will arise against utility rates than against any other institution under our property system (and probably less), because there is no arbitrary product to be ascertained. It is true that under the present predominance of fixed return securities that there would be some tendency to this, but if the Federal policy is enforced the ratio will not remain. If new capital can not be obtained at the price offered for its use, an increase of the base while the interest remains fixed does not (at least if the capitalization and the base are similar) make the reward any more attractive. Further, if an available base measured by constantly changing costs, as, for example, reproduction new, is used, on a falling trend of costs the dilemma may change to disaster. But with a fixed base and adjustable return, attractive interest rates may be maintained. Only profits have magnetism for capital. The importance to the lender of the addition of one dollar to the loan instead of to the interest is about 1 to 16. This abandons the attempt to warp on to large scale regulated monopoly or semi-monopoly the competitive enterprise economic theory. Automatic control of prices at just

about the point to attract new capital does not exist in the unregulated competitive fields, nor would the competitive price system be desirable in the regulated utility field. The focus of public interest is different as there is little regard for the financial necessities for the individual producer in the competitive field. Railroads are regulated—communities depend upon them, and the extent of governmental regulation is not diminishing.

APPENDIX I

Section 15A

THE CODE OF THE LAWS OF THE UNITED STATES OF AMERICA

TITLE 49.—TRANSPORTATION

Chapter 1.—"Interstate Commerce Act"

* * * * * * *

15a. Fair return for carriers; disposition of excess; loans and leases to carriers.—(*1*) *Definitions.*—When used in this section the term "rates" means rates, fares, and charges, and all classifications, regulations, and practices, relating thereto; the term "carrier" means a carrier by railroad or partly by railroad and partly by water, within the continental United States, subject to this chapter, excluding (a) sleeping-car companies and express companies, (b) street or suburban electric railways unless operated as a part of a general steam railroad system of transportation, (c) interurban electric railways unless operated as a part of a general steam railroad system of transportation or engaged in the general transportation of freight, and (d) any belt-line railroad, terminal switching railroad, or other terminal facility, owned exclusively and maintained, operated, and controlled by any State or political subdivision thereof; and the term "net railway operating income" means railway operating income, including in the computation thereof debits and credits arising from equipment rents and joint facility rents.

(*2*) *Rates to permit carriers to earn fair return.*—In the exercise of its power to prescribe just and reasonable rates the commission shall initiate, modify, establish or adjust such rates so that carriers as a whole (or as a whole in each of such rate groups or territories as the commission may from time to time designate) will, under honest, efficient and economical management and reasonable expenditures for maintenance of way, structures and equipment, earn an aggregate annual net railway operating income equal, as nearly as may be, to a fair return upon the aggregate value of the railway property of such carriers held for and used in the service of transportation: *Provided,* That the commission shall have reasonable latitude to modify or adjust any particular rate which it may find to be unjust or unreasonable, and to prescribe different rates for different portions of the country.

(3) *Determination of percentage constituting fair return.*—The commission shall from time to time determine and make public what percentage of such aggregate property value constitutes a fair return thereon, and such percentage shall be uniform for all rate groups or territories which may be designated by the commission. In making such determination it shall give due consideration, among other things, to the transportation needs of the country and the necessity (under honest, efficient and economical management of existing transportation facilities) of enlarging such facilities in order to provide the people of the United States with adequate transportation.

(4) *Determination of aggregate value of properties.*—For the purposes of this section, such aggregate value of the property of the carriers shall be determined by the commission from time to time and as often as may be necessary. The commission may utilize the results of its investigation under section 19a of this chapter, in so far as deemed by it available, and shall give due consideration to all the elements of value recognized by the law of the land for rate-making purposes, and shall give to the property investment account of the carriers only that consideration which under such law it is entitled to in establishing values for rate-making purposes. Whenever pursuant to section 19a of this chapter the value of the railway property of any carrier held for and used in the service of transportation has been finally ascertained, the value so ascertained shall be deemed by the commission to be the value thereof for the purpose of determining such aggregate value.

(5) *Amounts received by carriers in excess of fair return payable to United States.*—Inasmuch as it is impossible (without regulation and control in the interest of the commerce of the United States considered as a whole) to establish uniform rates upon competitive traffic which will adequately sustain all the carriers which are engaged in such traffic and which are indispensable to the communities to which they render the service of transportation, without enabling some of such carriers to receive a net railway operating income substantially and unreasonably in excess of a fair return upon the value of their railway property held for and used in the service of transportation, it is declared that any carrier which receives such an income so in excess of a fair return, shall hold such part of the excess, as hereinafter prescribed, as trustee for, and shall pay it to, the United States.

*(6) *Disposition of amounts received in excess of 6 per centum.*—If, under the provisions of this section, any carrier receives for any year a net railway operating income in excess of 6 per centum of the value of the railway property held for and used by it in the service of transportation, one-half of such excess shall be placed in a reserve fund established and maintained by such carrier, and the remaining one-half thereof shall, within the first four months following the close of the period for which such computation is made, be recoverable by and paid to the commission for the purpose of establishing and maintaining a general railroad contingent fund as hereinafter described. For the purposes of this paragraph the value of the railway property and the net railway operating income of a group of carriers, which the commission finds are under common control and management and are operated as a single system, shall be computed for the system as a whole irrespective of the separate ownership and accounting returns of the various parts of such system. The value of such railway property shall be determined by the commission in the manner provided in paragraph (4).

(7) *Payment of dividends, interest, or rent from reserve fund.*—For the purpose of paying dividends or interest on its stocks, bonds, or other securities, or rent for leased roads, a carrier may draw from the reserve fund established and maintained by it under the provisions of this section to the extent that its net railway operating income for any year is less than a sum equal to 6 per centum of the value of the railway property held for and used by it in the service of transportation, determined as provided in paragraph (6); but such fund shall not be drawn upon for any other purpose.

(8) *Maximum amount of reserve fund; use of surplus.*—Such reserve fund need not be accumulated and maintained by any carrier beyond a sum equal to 5 per centum of the value of its railway property determined as herein provided, and when such fund is so accumulated and maintained the portion of its excess income which the carrier is permitted to retain

*"The statutory provision constituting this paragraph contained the following sentence, omitted from the code, immediately preceding the last sentence:

" 'In the case of any carrier which has accepted the provisions of section 209 of the Transportation Act, 1920, the provisions of this paragraph shall not be applicable to the income for any period prior to September 1, 1920.'

"The code compilers assumed that the omitted sentence was too temporary to warrant insertion in the code, but it is still said to be essential to the proper administration of the law. 'Recapture' has not yet been definitely settled by the courts." (U. S. Code Sup. III.)

under paragraph (6) may be used by it for any lawful purpose.

(9) *Rules and regulations for recovery of excess income; computation thereof.*—The commission shall prescribe rules and regulations for the determination and recovery of the excess income payable to it under this section, and may require such security and prescribe such reasonable terms and conditions in connection therewith as it may find necessary. The commission shall make proper adjustments to provide for the computation of excess income for a portion of a year, and for a year in which a change in the percentage constituting a fair return or in the value of a carrier's railway property becomes effective.

(10) *General railroad contingent fund; use and disposition.*—The general railroad contingent fund so to be recoverable by and paid to the commission and all accretions thereof shall be a revolving fund and shall be administered by the commission. It shall be used by the commission in furtherance of the public interest in railway transportation either by making loans to carriers to meet expenditures for capital account or to refund maturing securities originally issued for capital account, or by purchasing transportation equipment and facilities and leasing the same to carriers, as hereinafter provided. Any moneys in the fund not so employed shall be invested in obligations of the United States or deposited in authorized depositaries of the United States subject to the rules promulgated from time to time by the Secretary of the Treasury relating to Government deposits.

(11) *Loan to carrier from contingent fund; application for.*—A carrier may at any time make application to the commission for a loan from the general railroad contingent fund, setting forth the amount of the loan and the term for which it is desired, the purpose of the loan and the use to which it will be applied, the present and prospective ability of the applicant to repay the loan and meet the requirements of its obligations in that regard, the character and value of the security offered, and the extent to which the public convenience and necessity will be served. The application shall be accompanied by statements showing such facts and details as the commission may require with respect to the physical situation, ownership, capitalization, indebtedness, contract obligations, operation, and earning power of the applicant, together with such other facts relating to the propriety and expediency of granting the loan applied for and the ability

of the applicant to make good the obligation, as the commission may deem pertinent to the inquiry.

(*12*) *Terms and conditions of granting loan to carriers.*—If the commission, after such hearing and investigation, with or without notice, as it may direct, finds that the making, in whole or in part, of the proposed loan from the general railroad contingent fund is necessary to enable the applicant properly to meet the transportation needs of the public, and that the prospective earning power of the applicant and the character and value of the security offered are such as to furnish reasonable assurance of the applicant's ability to repay the loan within the time fixed therefor, and to meet its other obligations in connection with such loan, the commission may make a loan to the applicant from such railroad contingent fund, in such amount, for such length of time, and under such terms and conditions as it may deem proper. The commission shall also prescribe the security to be furnished, which shall be adequate to secure the loan. All such loans shall bear interest at the rate of 6 per centum per annum, payable semiannually to the commission. Such loans when repaid, and all interest paid thereon, shall be placed in the general railroad contingent fund.

(*13*) *Lease to carrier of equipment purchased from contingent fund; application for.*—A carrier may at any time make application to the commission for the lease to it of transportation equipment or facilities, purchased from the general railroad contingent fund, setting forth the kind and amount of such equipment or facilities and the term for which it is desired to be leased, the uses to which it is proposed to put such equipment or facilities, the present and prospective ability of the applicant to pay the rental charges thereon and to meet the requirements of its obligations under the lease, and the extent to which the public convenience and necessity will be served. The application shall be accompanied by statements showing such facts and details as the commission may require with respect to the physical situation, ownership, capitalization, indebtedness, contract obligations, operation, and earning power of the applicant, together with such other facts relating to the propriety and expediency of leasing such equipment or facilities to the applicant as the commission may deem pertinent to the inquiry.

(*14*) *Terms and conditions of leasing equipment; rentals.*—If the commission, after such hearing and investigation, with or without notice, as it may direct, finds that the leasing to

the applicant of such equipment or facilities, in whole or in part, is necessary to enable the applicant properly to meet the transportation needs of the public, and that the prospective earning power of the applicant is such as to furnish reasonable assurance of the applicant's ability to pay promptly the rental charges and meet its other obligations under such lease, the commission may lease such equipment or facilities purchased by it from the general railroad contingent fund, to the applicant, for such length of time and under such terms and conditions as it may deem proper. The rental charges provided in every such lease shall be at least sufficient to pay a return of 6 per centum per annum, plus allowance for depreciation determined as provided in paragraph (5) of section 20 of this chapter, upon the value of the equipment or facilities leased thereunder. All rental charges and other payments received by the commission in connection with such equipment and facilities, including amounts received under any sale thereof, shall be placed in the general railroad contingent fund.

(*15*) *Purchase, maintenance, disposition, etc., of equipment by commission.*—The commission may from time to time purchase, contract for the construction, repair and replacement of, and sell equipment and facilities, and enter into and carry out contracts and other obligations in connection therewith, to the extent that moneys included in the general railroad contingent fund are available therefor, and in so far as necessary to enable it to secure and supply equipment and facilities to carriers whose applications therefor are approved under the provisions of this section, and to maintain and dispose of such equipment and facilities.

(*16*) *Rules and regulations.*—The commission may from time to time prescribe such rules and regulations as it deems necessary to carry out the provisions of this section respecting the making of loans and the lease of equipment and facilities.

(*17*) *Effect on rights of shippers.*—The provisions of this section shall not be construed as depriving shippers of their right to reparation in case of overcharges, unlawfully excessive or discriminatory rates, or rates excessive in their relation to other rates, but no shipper shall be entitled to recover upon the sole ground that any particular rate may reflect a proportion of excess income to be paid by the carrier to the commission in the public interest under the provisions of this section.

(*18*) *Retention of all earnings from new lines constructed.*—Any carrier, or any corporation organized to construct and operate a railroad, proposing to undertake the construction and operation of a new line of railroad, may apply to the commission for permission to retain for a period not to exceed ten years all or any part of its earnings derived from such new construction in excess of the amount heretofore in this section provided, for such disposition as it may lawfully make of the same, and the commission may, in its discretion, grant such permission, conditioned, however, upon the completion of the work of construction within a period to be designated by the commission in its order granting such permission. (Feb. 28, 1920, c. 91, § 422, 41 Stat. 488.)

APPENDIX II

The Valuation Act

THE CODE OF THE LAWS OF THE UNITED STATES OF AMERICA

TITLE 49.—TRANSPORTATION

Chapter 1.—"Interstate Commerce Act"

* * * * * * *

19a. Valuation of property of carriers.—(*a*) *Physical valuation of property of carriers; classification and inventory.*—The commission shall, as hereinafter provided, investigate, ascertain, and report the value of all the property owned or used by every common carrier subject to the provisions of this chapter. To enable the commission to make such investigation and report, it is authorized to employ such experts and other assistants as may be necessary. The commission may appoint examiners who shall have power to administer oaths, examine witnesses, and take testimony. The commission shall make an inventory which shall list the property of every common carrier subject to the provisions of this chapter in detail, and show the value thereof as hereinafter provided, and shall classify the physical property, as nearly as practicable, in conformity with the classification of expenditures for road and equipment, as prescribed by the Interstate Commerce Commission.

(*b*) *Cost of property; elements considered in determination; gifts, grants, etc.*—First. In such investigation said commission shall ascertain and report in detail as to each piece of property, other than land, owned or used by said common carrier for its purposes as a common carrier, the original cost to date, the cost of reproduction new, the cost of reproduction less depreciation, and an analysis of the methods by which these several costs are obtained, and the reason for their differences, if any. The commission shall in like manner ascertain and report separately other values, and elements of value, if any, of the property of such common carrier, and an analysis of the methods of valuation employed, and of the reasons for any differences between any such value and each of the foregoing cost values.

Second. Such investigation and report shall state in detail and separately from improvements the original cost of all lands, rights of way, and terminals owned or used for the purpose of a common carrier, and ascertained as of the time

of dedication to public use, and the present value of the same.

Third. Such investigation and report shall show separately the property held for purposes other than those of a common carrier, and the original cost and present value of the same, together with an analysis of the methods of valuation, employed.

Fourth. In ascertaining the original cost to date of the property of such common carrier the commission, in addition to such other elements as it may deem necessary, shall investigate and report upon the history and organization of the present and of any previous corporation operating such property; upon any increases or decreases of stocks, bonds, or other securities in any reorganization; upon moneys received by any such corporation by reason of any issues of stocks, bonds, or other securities; upon the syndicating, banking, and other financial arrangements under which such issues were made and the expense thereof; and upon the net and gross earnings of such corporations; and shall also ascertain and report in such detail as may be determined by the commission upon the expenditure of all moneys and the purposes for which the same were expended.

Fifth. The commission shall ascertain and report the amount and value of any aid, gift, grant of right of way, or donation, made to any such common carrier, or to any previous corporation operating such property, by the Government of the United States or by any State, county, or municipal government, or by individuals, associations, or corporations; and it shall also ascertain and report the grants of land to any such common carrier, or any previous corporation operating such property, by the Government of the United States, or by any State, county, or municipal government, and the amount of money derived from the sale of any portion of such grants and the value of the unsold portion thereof at the time acquired and at the present time, also, the amount and value of any concession and allowance made by such common carrier to the Government of the United States, or to any State, county, or municipal government in consideration of such aid, gift, grant, or donation.

(*c*) *Investigation; procedure and forms.*—Except as herein otherwise provided, the commission shall have power to prescribe the method of procedure to be followed in the conduct of the investigation, the form in which the results of the valuation shall be submitted, and the classification of the elements that constitute the ascertained value, and such in-

vestigation shall show the value of the property of every common carrier as a whole and separately the value of its property in each of the several States and Territories and the District of Columbia, classified and in detail as herein required.

(*d*) *Time for beginning investigation; reports to Congress.*—Such investigation shall be commenced within sixty days after March 1, 1913, and shall be prosecuted with diligence and thoroughness, and the result thereof reported to Congress at the beginning of each regular session thereafter until completed.

(*e*) *Aid of carrier required; rules and regulations; inspection of record.*—Every common carrier subject to the provisions of this chapter shall furnish to the commission or its agents from time to time and as the commission may require maps, profiles, contracts, reports of engineers, and any other documents, records, and papers, or copies of any or all of the same, in aid of such investigation and determination of the value of the property of said common carrier, and shall grant to all agents of the commission free access to its right of way, its property, and its documents, records, and memoranda whenever and wherever requested by any such duly authorized agent, and every common carrier is directed and required to cooperate with and aid the commission in the work of the valuation of its property in such further particulars and to such extent as the commission may require and direct, and all rules and regulations made by the commission for the purpose of administering the provisions of this section and section 20 of this chapter shall have the full force and effect of law. Unless otherwise ordered by the commission, with the reasons therefor, the records and data of the commission shall be open to the inspection and examination of the public.

(*f*) *Valuation of extensions and improvements; revisions; reports.*—Upon the completion of the valuation herein provided for the commission shall thereafter in like manner keep itself informed of all extensions and improvements or other changes in the condition and value of the property of all common carriers, and shall ascertain the value thereof, and shall from time to time, revise and correct its valuations, showing such revision and correction classified and as a whole and separately in each of the several States and Territories and the District of Columbia, which valuations, both original and corrected, shall be tentative valuations and shall be reported to Congress at the beginning of each regular session.

(*g*) *Reports and information to be furnished by carriers.*—To enable the commission to make such changes and corrections in its valuations of each class of property, every common carrier subject to the provisions of this chapter shall make such reports and furnish such information as the commission may require.

(*h*) *Notice of completion of tentative valuation; protests; finality of report.*—Whenever the commission shall have completed the tentative valuation of the property of any common carrier, as herein directed, and before such valuation shall become final, the commission shall give notice by registered letter to the said carrier, the Attorney General of the United States, the governor of any State in which the property so valued is located, and to such additional parties as the commission may prescribe, stating the valuation placed upon the several classes of property of said carrier, and shall allow thirty days in which to file a protest of the same with the commission. If no protest is filed within thirty days, said valuation shall become final as of the date thereof.

(*i*) *Protests; hearings; changes in valuations; final valuation and classification.*—If notice of protest is filed the commission shall fix a time for hearing the same, and shall proceed as promptly as may be to hear and consider any matter relative and material thereto which may be presented in support of any such protest so filed as aforesaid. If after hearing any protest of such tentative valuation under the provisions of this chapter the commission shall be of the opinion that its valuation should not become final, it shall make such changes as may be necessary and shall issue an order making such corrected tentative valuation final as of the date thereof. All final valuations by the commission and the classification thereof shall be published and shall be prima facie evidence of the value of the property in all proceedings under this chapter as of the date of the fixing thereof, and in all judicial proceedings for the enforcement of this chapter, and in all judicial proceedings brought to enjoin, set aside, annul, or suspend, in whole or in part, any order of the Interstate Commerce Commission.

(*j*) *Effect of evidence as to values; modification of orders.*—If upon the trial of any action involving a final value fixed by the commission evidence shall be introduced regarding such value which is found by the court to be different from that offered upon the hearing before the commission, or additional thereto and substantially affecting said value, the

court, before proceeding to render judgment, shall transmit a copy of such evidence to the commission and shall stay further proceedings in said action for such time as the court shall determine from the date of such transmission. Upon the receipt of such evidence the commission shall consider the same and may fix a final value different from the one fixed in the first instance, and may alter, modify, amend, or rescind any order which it has made involving said final value, and shall report its action thereon to said court within the time fixed by the court. If the commission shall alter, modify, or amend its order, such altered, modified, or amended order shall take the place of the original order complained of, and judgment shall be rendered thereon as though made by the commission in the first instance. If the original order shall not be rescinded or changed by the commission, judgment shall be rendered upon such original order.

(*k*) *Receivers and trustees of carriers affected; noncompliance with law; penalty.*—The provisions of this section shall apply to receivers of carriers and operating trustees. In case of failure or refusal on the part of any carrier, receiver, or trustee to comply with all the requirements of this section and in the manner prescribed by the commission such carrier, receiver, or trustee shall forfeit to the United States the sum of $500 for each such offense and for each and every day of the continuance of such offense, such forfeitures to be recoverable in the same manner as other forfeitures provided for in section 16 of this chapter.

(*l*) *Mandamus to compel compliance with law.*—The district courts of the United States shall have jurisdiction, upon the application of the Attorney General of the United States at the request of the commission, alleging a failure to comply with or a violation of any of the provisions of this section by any common carrier, to issue a writ or writs of mandamus commanding such common carrier to comply with the provisions of this section. (Mar. 1, 1913, c. 92, 37 Stat. 701; Feb. 28, 1920, c. 91, sec. 433, 41 Stat. 493; and June 7, 1922, c. 210, Secs. 1, 2, 42 Stat. 624.)

TABLE OF CASES

Ames v. Union Pacific Railway Company....16, 32, 64
Ann Arbor Railroad Company v. United States.... 36
Annual Report, 1908.... 29
Annual Reports, 1903, 1907-1911.... 36
Associated Press Report.... 60
Brooklyn-Gas Case....41, 44
Bay State Rate Case.... 22
Brooklyn Gas Co. v. City of New York.... 51
Bluefield Water & Improvement Co. v. Public Service Commission. 30
Cedar Rapids Gas Company v. Cedar Rapids....14, 30
Chicago, etc. Railway v. Minnesota.... 35
Chicago & Grand Trunk Ry. Company v. Wellman.... 64
Dayton-Goose Creek Railway Company v. United States.... 51
Des Moines Gas Company v. Des Moines....14, 26, 30, 42
Douglas County Light and Water Company Case.... 22
Fifteen Percent Case. 1931.... 21
Galveston Electric Company v. Galveston....14, 30
Georgia Power Company v. The Railroad Commission.... 30
Hicks v. Guiness.... 61
Hill v. Antigo Water Company.... 22
House Report No. 477, H. R. 225993.... 46
House Report No. 456, 66th Congress, 1st Session....55, 56
Illinois Terminal Company, Excess Income of.... 14
Increased Rates. 1920.... 21
Interstate Com. Comm. v. Alabama Midland Ry. Company.... 36
Interstate Com. Comm. v. Cincinnati Railway Company.... 36
Kansas City R. R. Company v. United States.... 66
Knoxville v. Knoxville Water Company....14, 37
Louisiana General Tax Law. Act No. 170 of 1898.... 14
Manufacturers Railway Company, Excess Income of.... 16
Minnesota Rate Case (Simpson v. Shepard) (See below)....
Missouri ex rel. Southwestern Bell Tel. Co. v. Public Service Commission....28, 29, 48
Munn v. Illinois.... 35
McCardle v. Indianapolis Water Company.... 27
Newton v. Consolidated Gas Company of New York....15, 48
New York Central Acquisition of Ulster & Delaware.... 14
Omaha v. Omaha Water Company.... 61
Ottinger v. Consolidated Gas Company.... 18
Pacific Gas & Electric Company v. San Francisco....24, 30
Prentis v. Atlantic Coast Line.... 35
Public Utility Commissioners v. New York Telephone Company... 25
Railroad Commission v. Chicago, B. & Q. Railroad.... 35
Reduced Rates. 1922.... 21
Regan v. Farmers Loan & Trust Company.... 32
Re City of Grand Rapids.... 22
Sections 417, 419, Transportation Act.... 71
Senate Report 1290, 62nd Congress, 3d Session....15, 46
Senate Report No. 304, 66th Congress, 1st Session....54, 68

Simpson v. Shepard.....14, 25, 26, 37
Skinner and Eddy Corporation v. United States..... 53
Smyth v. Ames.....15, 26, 30, 32, 38, 45, 47
Stanislaus County v. San Joaquin, etc.....14, 30
State v. Department of Public Works..... 72
San Diego Land and Loan Company v. Jasper.....14, 30, 37
San Diego Land and Loan Company v. National City.....14, 30, 37
St. Louis & O'Fallon Ry. Co. v. United States.....28, 29
St. Paul Book Company v. St. Paul Gas Light Company..... 51
Transportation Act.....33, 51, 53, 59, 64, 67, 68
United Fuel Gas Company v. The Railway Commission..... 18
United Railways and Electric Company v. West.....48, 66
United States v. Ludey..... 27
Valuation Act.....37, 64, 68
Westchester Street Railway Case.....
Wilcox v. Consolidated Gas Company.....14, 26, 30

INDEX

INDEX

(The figures refer to pages)

AMORTIZATION
As an operating expense 49

CONDEMNATION
Relation to value for rate-making 14, 15
Value for purposes of 14

DEPRECIATION
Relevancy to value 47
Under original cost 30
Under Federal income laws 31
Under historical cost 33

EARNING POWER
As a measure of value 14
Not a test under Smyth v. Ames 15
Rejection by Supreme Court 14
Relation to rate-making 15
Taking property by reduction of 14

EXPENDITURE
Honesty and economy in 24, 64

FAIR RETURN
Additional capital as measure of 54
Analogy to interest 62
Constitutional right of 24, 44
Judicial test of 66
Legislative declaration of 56
Relation to financial stability 60
Relation to market norm 54
Six percentum constitutes 57
Test of constitutional right of 39
Transportation Act, provisions for 52, 53, 59

FUNCTIONAL DEPRECIATION
Accounting practice 24
Relation to rate-making value 24

GOING VALUE
Under original cost 30
Under historical cost 33
Under Smyth v. Ames 42
Under statue 44

HISTORICAL COST AS RATE BASE
Defects of 33, 34
Importance of 45
Merits of 33
Stability of return under 33
Under Transportation Act 33
What is included under 32

INCOME
Nature of 62

LEGISLATION
Necessity of, for railroads 10

MARKET VALUE
Measure of 13
Relation to exchange value 14

OBSOLESCENCE
Effect on value 17

ORIGINAL COST AS RATE BASE
As an evidenciary fact 30, 32
As exclusive measure 29, 32
As financial sacrifice of security holders 29
Frugality of expenditure 29
Simplicity of administration 31

PRESENT VALUE
Relation to rate base 47
Relation to return 48
Under the Baltimore Railway Case 48

PRUDENT INVESTMENT AS RATE BASE
Importance of 45, 68
Measure of value under 33
Relation to historical cost 32

RATE BASE
Analogy to condemnation 60
Analogy to debtor-creditor relationship 61
Conclusiveness of 45, 47
Cost of reproduction new under 44
Determination as a judicial function 35
Finality of determination of 68, 69
Measure of, under Smyth v. Ames 39, 63
Measure of, under statute 43, 63
Original cost under 43

RATES
Determination of, as a legislative function 35
Frequency of adjustment 67, 71
History of power to fix 36
Operation in future 35, 64
Policy in fixing 49
Relation to return 67
When set aside 36

REASONABLE RETURN
See Fair Return.

RECAPTURE
Amendment of statute 10
Legislative purpose 51

RECONNAISSANCE, COST OF
Allowance for 26, 34

REPRODUCTION OF THE PLANT AS RATE BASE
As source of new construction 18
History of carrier's claim for 16
Importance of 45
Instability of 19
Relation to earnings 17
Scrap value 17
Social loss as test for 17
Stability of return under 19, 20
Under the McCardle Case 26, 27
Under the Valuation Act 28
Uncertainty of amount 18

REPRODUCTION OF THE SERVICE AS RATE BASE
As a fact evidentiary of value 26, 27
Effect of obsolescence 23
Relation to cost of reproduction of plant 23, 25
Relation to cost 26
Under the New York Telephone Case 25

RETURN
Measure of 34, 35, 39
Relation to base 73
Stability in 72

REVALUATION
Necessity of 29, 40, 45, 46, 47, 71

SECURITY ISSUES
Classes of, outstanding 65, 73
Effect of water in 68
Preference in 72
Relation to the rate base 44, 45, 46
When attractive to investors 54

TAXATION
Relation to value for rate-making 14
Test rejected in Smyth v. Ames 39
Value for purposes of 14, 15
Value for, rejection by Congress 15

THEORIES OF VALUATION
Confusion of expression in 13

UNEARNED INCREMENT
Claim for 17
Under original cost 30

WORKING CAPITAL
Included in rate base 44